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How Long Can This Go On? The Controversy Over the Application of the Statute of Limitations to S Corporations and Their Shareholders

J. Marcus Sommers*

I. INTRODUCTION

In *Bufferd v. Commissioner*,¹ the Supreme Court resolved the dispute involving the proper application of the statute of limitations to an S corporation and its shareholders.² Contrary to the holding of the Ninth Circuit Court of Appeals in *Kelley v. Commissioner*³ and the argument made by several taxpayers, the Supreme Court ruled that the statute of limitations for the assessment of tax against the shareholder of an S corporation commences with the filing of that shareholder's personal return.⁴ In so ruling, the Court agreed with the Fifth, Eleventh, and Second Circuit Courts of Appeal.⁵

* The author is currently an associate with the St. Louis office of Bryan Cave. The author wishes to express his appreciation to Professor Paul C. Feinberg, without whom this article would not have been completed. The author also wishes to express his appreciation for the helpful comments of Ms. Jean Jones, Ms. Paula Hosler, Professor Chris Hoyt, Professor Patrick Randolph, Mr. Richard Smith, Ms. Diana Erbsen and Mr. Jeff McFall.

1. 113 S. Ct. 927 (1993), *aff'g* 952 F.2d 675 (2d Cir. 1992).

2. *Id.*

3. 877 F.2d 756 (9th Cir. 1989) (holding that the statute of limitations barred the Service's assessment to an S corporation shareholder after the statute of limitations for the S corporation's return had expired). *Kelley* was cited with approval by the Eighth Circuit Court of Appeals in *Fendall v. Commissioner*, 906 F.2d 362 (8th Cir. 1990).

4. *Bufferd*, 113 S. Ct. at 927.

5. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992); *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992).

In general, section 6501(a) of the Internal Revenue Code of 1986⁶ (hereinafter "the Code") provides that the Internal Revenue Service (hereinafter "the Service") has three years from the time a return is filed to assess a tax.⁷ This general rule applies to both individual and corporate taxpayers. A dispute arose, however, about whether this three year statute of limitations barred the Service from assessing a tax against an S corporation shareholder, with respect to tax items originally reported on the S corporation's return, after the expiration of the statute of limitations for the S corporation's return.

This article critically examines the reasoning of the Supreme Court in *Bufferd v. Commissioner*,⁸ as well as the reasoning of other courts on this issue.⁹ This article further examines how the reasoning of these courts affects the general application of the statute of limitations for assessments of tax by the Service. This analysis focuses on two distinct issues: (1) whether the language of the Code requires the return of an S corporation to be treated as a "return" within the meaning of section 6501(a) of the Code;¹⁰ and (2) the proper application of the statute of limitations provision.¹¹

This article begins by discussing the general tax concepts that are encountered in analyzing the foregoing issues.¹² Next, the article briefly considers the rules of statutory construction to determine how the statutory language and the legislative history should be used to interpret the statutes.¹³ The article then focuses on the interaction of code sections 6012 and 6037(a) as they apply to the statute of limitations for assessment defined in code section 6501(a).¹⁴ Included in the discussion of the statutory provisions is an examination of their

6. All section references in the article, unless otherwise indicated, are to the Internal Revenue Code of 1986 (hereinafter "the Code") as amended.

7. I.R.C. § 6501(a) (1993). Section 6501(a) states:

(a) GENERAL RULE.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

8. 113 S. Ct. 927 (1993).

9. Green, 963 F.2d at 783; Fehlhaber, 954 F.2d at 653; Bufferd, 952 F.2d at 675; Kelley v. Commissioner, 877 F.2d at 756 (9th Cir. 1989).

10. See *infra* notes 122-84 and accompanying text.

11. See *infra* notes 306-31 and accompanying text.

12. See *infra* notes 18-98 and accompanying text.

13. See *infra* notes 99-121 and accompanying text.

14. See *infra* notes 122-58 and accompanying text.

legislative history.¹⁵ After analyzing the law and the legislative history, the article examines how the courts interpret and apply the law in this controversial setting.¹⁶ Finally, this article discusses the policy concerns raised by this dispute.¹⁷

A. *Tax Years*

To fully grasp the nature of the dispute, it is necessary to understand the two alternative taxable years that a taxpayer may adopt because of the significant tax ramifications which arise from such selection.

1. Calendar Year

A "calendar year" taxpayer has a taxable year that begins on January 1 and ends on December 31.¹⁸ The taxpayer reports all items of tax (income, deductions, etc.) for the taxable year on his applicable return.¹⁹ In the case of an individual, the return must be filed by the April 15 following the end of the calendar year.²⁰ In the case of a "calendar year corporation," the return must be filed by the March 15 following the end of the calendar year.²¹ After the filing of a tax return, the Service generally has three years to make assessments of tax with respect to

15. See *infra* notes 159-84 and accompanying text.

16. See *infra* notes 185-331 and accompanying text.

17. See *infra* notes 332-55 and accompanying text.

18. See I.R.C. § 441(d) (1993). Section 441(d) states: "For purposes of the subtitle, the term 'calendar year' means a period of 12 months ending on December 31." *Id.*

19. *Id.* § 6012(a)(1)(A) (1993). Section 6012(a)(1)(A) requires an individual to file a return. Section 6012(a)(1)(A) states: "Returns with respect to income taxes under subtitle A shall be made by the following: (1)(A) Every individual having for the taxable year gross income which equals or exceeds the exemption amount" *Id.*

20. *Id.* § 6072(a). I.R.C. Section 6072(a) states in relevant part: "In the case of returns under section 6012, 6013, 6017, or 6031 (relating to income tax under subtitle A), . . . returns made on the basis of a fiscal year shall be filed on or before the 15th day of the fourth month following the close of the fiscal year," *Id.*

21. *Id.* § 6072. Section 6072(b) provides:

Returns of corporations under section 6012 made on the basis of the calendar year shall be filed on or before the 15th day of March following the close of the calendar year, and such returns made on the basis of a fiscal year shall be filed on or before the 15th day of the third month following the close of the fiscal year. Returns required for a taxable year by section 6011(e)(2) (relating to returns of a DISC) shall be filed on or before the fifteenth day of the ninth month following the close of the taxable year.

Id.

that return.²² If the Service attempts to make an assessment after three years, the taxpayer may raise the statute of limitations as an affirmative defense.²³

2. Fiscal Year

A "fiscal year taxpayer" has a taxable year that ends on the last day of any calendar month other than December.²⁴ For example, a taxpayer with a taxable year beginning on September 1 and ending on August 31 would be a fiscal year taxpayer. Most fiscal year taxpayers are not individuals. A "fiscal year corporation" must file a tax return²⁵ that reports the corporation's tax items at the end of its fiscal year.²⁶ As with a calendar year taxpayer, the Service may be barred from making assessments of tax with respect to that return three years after the return is filed.²⁷

B. Pass-Through Entities

Every entity required by the Code to file a return is not necessarily required to pay tax. The Code requires that partnerships and S corporations file partnership²⁸ and corporate tax returns,²⁹ respectively. However, these business organizations generally do not pay tax at the partnership³⁰ or corporate³¹ level. Instead, the tax items of the part-

22. *Id.* § 6051(a); *see supra* note 7 for applicable text.

23. I.R.C. sections 1311-1315 provide for adjustments to a taxpayer's liability in certain limited situations even though the determination would otherwise be prevented by operation of law. Generally, the limited situations could, but do not necessarily, arise in the dispute addressed in this article. For purposes of this article, it is assumed that the situations involving the application of Code §§ 1311-1315 do not arise.

24. I.R.C. § 7701(a)(24) (1993). Section 77601(a)(24) states: "When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof . . . [t]he term 'fiscal year' means an accounting period of 12 months ending on the last day of any month other than December." *Id.*

25. *Id.* § 6012(a)(2) (1993); *see infra* text accompanying note 129 for text.

26. The return of a fiscal year corporate taxpayer must be filed within the time constraints proscribed by I.R.C. section 6072(b) (1993); *see supra* note 21 for text.

27. I.R.C. § 6501(a) (1993); *see supra* note 7 for text.

28. I.R.C. § 6031(a) (1993) (partnerships); *see infra* note 142 for text.

29. I.R.C. § 6037(a) (1993) (S corporations); *see infra* text accompanying note 140 for text.

30. I.R.C. § 701 (1993). Section 701 provides that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." *Id.*

31. *Id.* § 1363(a). Section 1363 states in relevant part that "[e]xcept as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter." *Id.*

nership or the S corporation are reported on the return of each individual partner³² or shareholder.³³ Because tax items of the S corporation or partnership are "passed through" the business entity and reported on the return of the individual shareholder or partner, S corporations and partnerships are called "pass-through entities." The tax items of a "pass-through entity" are reported twice—first by the pass-through entity filing its tax return, and again when each partner or shareholder declares his share of the pass-through entity's income or loss on his individual return.

The dispute surrounding the filing of the tax return for an S corporation or a partnership is whether the business return or the shareholder/partner return, starts the Service's three year limitation period for making assessments of tax attributable to income, deductions or other information reportable by the business.³⁴ More precisely, the issue is whether the Service is barred from making assessments to the individual tax return relating to tax items first reported on the S corporation or partnership return after the three year statute of limitations period for the business return expires.

1. Corporate Taxation: An Overview

A corporation comes into existence upon the filing of its articles of incorporation with a state.³⁵ The corporation is a separate legal entity,

32. See I.R.C. § 701 (1993); see *supra* note 30 for text.

33. *Id.* § 1366(a). Section 1366(a), which establishes the income of a shareholder in an S corporation, provides:

In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income (including tax-exempt income), loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

34. See, e.g., *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992); see also *Siben v. Commissioner*, 930 F.2d 1034 (2d Cir. 1991).

35. See 3 ZOLMAN CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 51.02[2][a](1) (1991).

a new legal "person." This new legal person can enter into contracts, sue or be sued, and pay taxes.³⁶

The corporation must file a tax return at the end of its taxable year.³⁷ The corporation selects the date that marks the end of the corporation's taxable year.³⁸ If the date that represents the end of the selected taxable year is December 31, the corporation is a calendar year taxpayer.³⁹ If the corporation selects the last day of any other calendar month to mark the end of its taxable year, the corporation is a fiscal year taxpayer.⁴⁰

2. C Corporations

A "regular" or "C corporation"⁴¹ pays tax on its income.⁴² If the corporate earnings are distributed to the shareholders in the form of dividends, the shareholders pay a tax on these receipts.⁴³ This is the concept of "double taxation of corporate income." One tax is paid by a corporation on its income and a second tax is paid by the shareholder when the corporation distributes its after-tax income to the shareholder as a dividend.⁴⁴ This "double taxation" is the primary disadvantage of using the "C corporation" as a method of conducting business.

3. S Corporations

Congress enacted Subchapter S of the Code to ameliorate the harsh tax consequences of operating a small business as a corporation.⁴⁵ Subchapter S allows "qualifying small businesses" to elect to be taxed ac-

36. *Id.* § 50.03[1].

37. I.R.C. § 6012(a)(2) (1993); *see infra* text accompanying note 129 for text.

38. Temp. Treas. Reg. § 1.441-1T(b)(2) (as amended in 1987). Regulation 1.441-1T(b)(2) states: "A new taxpayer adopts a taxable year on or before the time prescribed by law (not including extensions) for the filing of the taxpayer's first return and may adopt, without prior approval, any taxable year that satisfies the requirements of section 441 and this section." *Id.*

39. *See* I.R.C. § 441(d) (1993); *see supra* note 18 for text.

40. I.R.C. § 7701(a)(24) (1993); *see supra* note 24 for text.

41. A "regular" or "C corporation" is any corporation that has not properly elected to be an S corporation.

42. I.R.C. § 11 (1993). Section 11 states: "A tax is hereby imposed for each taxable year on the taxable income of every corporation." *Id.*

43. *Id.* § 61(a)(7).

44. Consider this example: X corporation, a calendar year taxpayer, earned taxable income of \$1,000 in 1991. Also in 1991, X corporation paid a \$100 dividend to its shareholder A. X corporation is required to pay tax on \$1,000 of income for 1991 despite X's payment of \$100 to A as a dividend. In addition, A is required to pay tax on the \$100 dividend.

45. *See* S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

ording to the rules of Subchapter S instead of being taxed like a C corporation.⁴⁶ A "qualifying small business"⁴⁷ that elects to be taxed pursuant to Subchapter S is known as an "S corporation."

Generally, an S corporation does not pay income tax at the corporate level.⁴⁸ Instead, the tax items of the S corporation pass through to the shareholders.⁴⁹ In effect, it is as if the corporation does not exist and the shareholder earns the income or sustains the loss. Therefore, the investors in an S corporation are entitled to the protections offered by state corporation law, such as limited liability, without incurring the disadvantage of double taxation discussed above.

Similar to a C corporation, the S corporation files a return at the end of its tax year.⁵⁰ After the S corporation files its return, it sends each shareholder a Form K-1,⁵¹ which provides information that must be included on the shareholder's individual return.⁵²

Because the S corporation files its tax return after the close of its taxable year,⁵³ the shareholder reports the S corporation tax items on his individual return after the close of the S corporation's taxable year. If the S corporation's taxable year ends on the same day as the shareholder's taxable year, there is a one month delay between the S corporation's filing date of March 15 and the shareholder's filing date of April 15.⁵⁴ If the S corporation's taxable year ends on a different day than the shareholder's taxable year, the delay between the filing of the S corporation return and the shareholder's return is greater than one

46. See I.R.C. § 1363(a) (1993); see *supra* note 31 for text.

47. I.R.C. § 1361(b) (1993). A small business corporation is allowed to make an S corporation election if it meets the requirements of section 1361(b), which provides:

For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—

- (A) have more than 35 shareholders,
- (B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,
- (C) have nonresident alien as a shareholder, and
- (D) have more than 1 class of stock.

Id.

48. See *id.* § 1363(a); see *supra* note 31 for text.

49. I.R.C. § 1366(a); see *supra* note 33 for text.

50. I.R.C. § 6037(a) (1993); see *infra* text accompanying note 140 for text.

51. I.R.S. Tax Info. Publication 589 (1991).

52. See I.R.C. § 1366(a) (1993); see *supra* note 33 for text.

53. I.R.C. § 6072(b) (1993); see *supra* note 21 for text.

54. See *supra* notes 18-23 and accompanying text.

month.⁵⁵

Because the S corporation shareholder does not pay tax on the S corporation income until that income is reported on the shareholder's return, the shareholder delays paying the tax due on that income. This delay is known as "tax deferral." Tax deferral is beneficial because it allows the taxpayer, rather than the government, to earn investment income on the delayed payment.

4. The Dispute: The Statute of Limitations and the Returns of an S Corporation and Their Shareholders

The issue of when the statute of limitations begins to run on S corporation tax items becomes particularly significant in two situations. The first situation concerns S corporation shareholders who wish to take advantage of the economic benefits of tax deferral.⁵⁶ The second situation concerns the audit of a shareholder in an S corporation. Often, when conducting an audit, the Service will seek the taxpayer's permission to extend the statute of limitations on the tax items reported on his individual return.⁵⁷ If the taxpayer is an S corporation shareholder, the extension of the statute of limitations for the individual shareholder does not extend the statute of limitations for the S corporation tax items.⁵⁸ In either situation, if the statute of limitations begins with the filing of the S corporation return, the Service is barred from making an assessment with respect to the S corporation tax items reported on the S corporation's or the shareholder's return after the statute of limitations for the S corporation return has expired.⁵⁹

55. For example, if an S corporation's taxable year ended March 31, 1990, its tax return would be due June 15, 1990. The shareholder would not report the S corporation's income on his/her individual income tax return until filing an individual return for the taxable year ending December 31, 1990 on April 15, 1991. Ten months would elapse between the time when the items were first reported on the S corporation's tax return and the time when they would be reported on the shareholder's individual return.

56. See *supra* section I(B)(3).

57. I.R.C. § 6501(c)(4) (1993). Section 6501(c)(4) states:

Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

Id.

58. See *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989).

59. *Id.*; but see *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993), *aff'g* 952 F.2d 675 (2d Cir. 1992); *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992); *Fehlhaber v.*

To elaborate, the S corporation has a two-tiered reporting system. The S corporation files a return that reports items such as income and deductions for the S corporation.⁶⁰ The shareholder includes his share of the S corporation items when he files his individual tax return.⁶¹ Because the S corporation return is filed before the shareholder's return, the statute of limitations for the S corporation return expires before that of the shareholder's. For a period of time, the Service can continue to make assessments with respect to the shareholder's return, but not the S corporation's return. If the S corporation return starts the statute of limitations running, the Service should not be able to adjust the S corporation tax items reported on the shareholder's return after the statute of limitations on the S corporation return has expired, even if the Service can adjust other tax items on the shareholder's return unrelated to the S corporation.

If the Service is allowed to make assessments regarding the S corporation items on the shareholder's return, the Service is, in effect, making assessments attributable to items reported on the S corporation return after the expiration of the three year limitation period. Because the tax items of an S corporation are also reported on the shareholder's return, an adjustment to the S corporation's tax return results in a corresponding adjustment to the shareholder's tax items. In reverse, if the Service adjusts the S corporation tax items on an individual shareholder's return, it has, in effect, made an adjustment to the S corporation return. Therefore, if the Service makes an assessment with respect to the S corporation items reported on a shareholder's return after the statute of limitations for the S corporation's return has run, the Service effectively extends the statute of limitations for the S corporation return.⁶²

As an illustration, consider the following example. Assume that X is an S corporation with two equal shareholders, A and B. X's taxable year ends August 31, 1990, and X files a timely return on November 15, 1990. A and B are calendar year taxpayers whose returns are due on April 15,

Commissioner, 954 F.2d 653 (11th Cir. 1992).

60. I.R.C. § 6037(a) (1993); *see infra* text accompanying note 140 for text.

61. I.R.C. § 1366(a) (1993); *see supra* note 33 for text.

62. This scenario can also result in unequal tax treatment for shareholders in the same S corporation. If the Service makes an assessment attributable to an S corporation tax item on one shareholder's return, but fails to make an assessment of tax for the same item on other shareholders' tax returns, similarly situated taxpayers have inequitable tax liabilities for the same tax items.

1991. When A and B file their tax returns, their returns will reflect the income and deductions passed through from X corporation. The Service determines that X corporation should have reported \$10,000 more in taxable income or disallows a \$10,000 deduction. The Service issues a notice of deficiency on February 1, 1994. The notice is issued more than three years after X corporation filed its return, but less than three years after the shareholders, A and B, filed their returns. So, while the statute of limitations on the return filed by X corporation has expired, A and B may each be required to pay tax on an additional \$5,000 of income attributable to X corporation.

The Service takes the position that the S corporation return, filed pursuant to section 6037, is an "informational return" that does not trigger the running of the statute of limitations.⁶³ According to this reasoning, it is not until the shareholders report the S corporation tax items on their personal returns that the statute of limitations begins to run. If the Service, therefore, makes an assessment of tax related to an item reported on an individual's return within the three year limitations period, the assessment is valid even if it relates to an item of tax first reported on the S corporation return.

Many taxpayers have argued, however, that a better interpretation of the statutory language of section 6037 is that the S corporation return is the type of return that starts the statute of limitations running.⁶⁴ If the S corporation's return starts the statute of limitations running, the Service is barred from making an assessment attributable to S corporation tax items on a shareholder's return after the statute of limitations on the S corporation return expires.⁶⁵ This interpretation, in effect, prevents the Service from making assessments that relate to S corporation items on the shareholder's tax return even though the three year limitation period for assessment on the shareholder's tax items unrelated to the S corporation has not expired.

C. *The Case Law*

The issue of whether the S corporation's return starts the statute of limitations running against the Service or whether the statute of limitations begins only with the filing of the shareholder's return was first addressed by the Tax Court in *Leonhart v. Commissioner*.⁶⁶ In

63. *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989), *action on decision*, 1986-405 (Apr. 8, 1991).

64. *See, e.g., Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992).

65. I.R.C. § 6501(a) (1993); *see supra* note 7 for text.

66. 27 T.C.M. (CCH) 443 (1968), *aff'd per curiam on other issues*, 414 F.2d 749 (4th Cir. 1969).

Leonhart, the Service issued a notice of deficiency to two shareholders of an S corporation.⁶⁷ The shareholders claimed that the Service was barred from making assessments on those tax items that were attributable to the S corporation because the statute of limitations for the S corporation's return had already expired.⁶⁸ The shareholders argued that the return filed by the S corporation, as required by section 6037(a),⁶⁹ started the three year statute of limitation for assessment prescribed in section 6501(a).⁷⁰

The Tax Court reasoned that because S corporations do not pay tax, there is no event which triggers the running of the statute of limitations.⁷¹ In interpreting section 6037(a), the Tax Court relied on a piece of legislative history relating to the return requirement of section 6037.⁷² The Tax Court concluded that Congress intended the S corporation's return to start the statute of limitations only if the corporation's subchapter S status were later revoked.⁷³

The Tax Court did not reexamine the issue of whether the S corporation return triggers the section 6501(a) statute of limitations until 1986, with the case of *Kelley v. Commissioner*.⁷⁴ In *Kelley*, the Service disallowed an S corporation deduction and assessed additional tax liability on the individual shareholders after the three year statute of limitations had run on the S corporation return.⁷⁵ The Tax Court once again affirmed the Service's determination.⁷⁶ The Tax Court noted that the statute of limitations could not start with the filing of the S corporation return because the S corporation was not assessed any tax.⁷⁷ The Tax Court cited *Leonhart* and *United States v. Adams Building Company*⁷⁸ to support its position that the filing of the S corporation return starts

67. *Id.* at 444.

68. *Id.* at 462.

69. For the text of I.R.C. § 6037(a) see *infra* text accompanying note 140.

70. See *Leonhart*, 27 T.C.M. at 462. For the text of I.R.C. § 6501(a) see *supra* note 7.

71. See *Leonhart*, 27 T.C.M. at 462.

72. See *id.* at 462-63. This passage of legislative history was also relied on by the Tax Court and the Eleventh Circuit in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1989) *aff'd*, 954 F.2d 653 (11th Cir. 1992). See *infra* notes 159-84 and accompanying text.

73. See *Leonhart*, 27 T.C.M. at 462.

74. 52 T.C.M. (CCH) 313 (1986).

75. *Id.* at 314.

76. *Id.* at 315.

77. *Id.* at 314.

78. 531 F.2d 342, 343 (6th Cir. 1976).

the statute of limitations running only when the S corporation status is later revoked.⁷⁹ The Tax Court again quoted the legislative history previously cited in *Leonhart*.⁸⁰ On the heels of *Kelley*, the Tax Court decided the case of *Jacobsson v. Commissioner*.⁸¹ Predictably, the Tax Court relied on *Leonhart*, *Kelley*, and the legislative history to find against the taxpayer.⁸²

In 1989, the Ninth Circuit reopened what appeared to be a closed issue by overturning the Tax Court's decision in *Kelley v. Commissioner*.⁸³ The Ninth Circuit reasoned that section 6037(a) required the Service to treat an S corporation return as a return that started the statute of limitations period.⁸⁴ The court noted that the purpose of a statute of limitations was to close the books on a tax year.⁸⁵ The court observed that the Service would not be prejudiced by having the statute of limitations run with the filing of the corporate return because the Service could request that the corporation extend its limitation period.⁸⁶ The Ninth Circuit ruled that the Tax Court erred in interpreting the legislative history as requiring the Service to treat the S corporation return as starting the statute of limitations *only* when the S election is later determined to be invalid.⁸⁷ The Ninth Circuit also noted that the section 6501(a) statute of limitations does not start running when tax is assessed, but rather with the filing of "some return."⁸⁸

In light of the Ninth's Circuit's decision, the Tax Court reconsidered its interpretation of sections 6037(a) and 6501(a) in *Fehlhaber v. Commissioner*.⁸⁹ The Tax Court chose not to follow the Ninth Circuit⁹⁰ and reaffirmed its own interpretation of the legislative history of sec-

79. *Kelley*, 52 T.C.M. at 314.

80. *Id.* at 314-15.

81. 54 T.C.M. (CCH) 1043 (1986) (holding that the Service could assess a shareholder of an S corporation for items reported on the S corporation return after the statute of limitations on the S corporation return expired).

82. *Id.* at 1044.

83. 877 F.2d 756 (9th Cir. 1989), *action on decision*, 1986-405 (Apr. 8, 1991).

84. 877 F.2d 756, 758 (9th Cir. 1989).

85. *Id.*

86. *Id.*

87. *Id.* at 759 (emphasis added).

88. *Id.*

89. 94 T.C. 863 (1990).

90. The Tax Court observed that the appeal in the *Fehlhaber* case would lie within the Eleventh Circuit and, citing *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), decided not to follow the Ninth Circuit's opinion in *Kelley v. Commissioner*. In *Golsen*, the Tax Court ruled that the law applied to a dispute would be the law of the circuit court of appeals hearing the case. Since this case would be a case of first impression in the Eleventh Circuit, the Tax Court allowed the discretion of a similarly situated district court.

tion 6037 first put forth in *Leonhart*.⁹¹ The Tax Court cited as additional authority a passage from the legislative history of the unified assessment provisions enacted by Congress in 1982.⁹² In that passage Congress commented on how under "present law," which was section 6037, the statute of limitations applied at the individual level.⁹³ The Tax Court also addressed the policy concerns of the Ninth Circuit and found them unpersuasive.⁹⁴

A clear split in the circuit courts of appeal was created when the Eleventh Circuit affirmed the Tax Court decision in *Fehlhaber*.⁹⁵ The Fifth and Second Circuits issued opinions concerning section 6037 that aligned them with the Eleventh Circuit and the Tax Court.⁹⁶ The Eighth Circuit favored the result reached by the Ninth Circuit.⁹⁷ Recognizing a split in the circuit courts of appeal on this issue, the Supreme Court granted certiorari to the Second Circuit case and resolved the dispute in favor of the Service.⁹⁸

II. STATUTORY CONSTRUCTION

The first step in construing a statute is to look at its plain language.⁹⁹ No other rules of statutory construction are applied unless a court determines that the meaning of the plain language of the statute is ambiguous.¹⁰⁰ However, a court's proper role is to determine what effect to give to the language of the legislature.¹⁰¹ Thus, if the court finds that the plain language of a statute is "ambiguous," or its application would clearly violate legislative intent, the court may look beyond

91. *Fehlhaber*, 94 T.C. at 867.

92. *Id.* (citing S. REP. NO. 640, 97th Cong., 2d Sess. 25 (1982)).

93. *Id.* (citing S. REP. NO. 640, 97th Cong., 2d Sess. 25 (1982)).

94. *Id.* at 869-70.

95. *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992), *aff'g* 94 T.C. 863 (1990).

96. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992); *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992)

97. *Fendall v. Commissioner*, 906 F.2d 362, 364 (8th Cir. 1990) (citing *Kelly v. Commissioner*, 877 F.2d 756 (9th Cir. 1989)) (holding that the Service can not make assessments on beneficiaries of a trust relating to trust tax items after the statute of limitations for making assessments to the trust have run).

98. *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993).

99. 1 JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION, § 3.05 (rev. ed. 1993).

100. *Id.* § 3.07.

101. *Id.* § 3.01.

the language of the statute.¹⁰² The first source beyond the statutory language to which a court looks to determine the intent of the legislature is the committee reports.¹⁰³ If the committee reports are silent or confusing as to the legislative intent, a court may look to other documents of the legislative history such as congressional debates and comments made by individual senators.¹⁰⁴

If a court cannot adequately discern legislative intent from the statutory language or the legislative history, it then applies the rule of construction for ambiguity.¹⁰⁵ Note that the rule of construction for ambiguity is applied only after concluding that the statutory language and the legislative history do not adequately reveal the legislative intent underlying the statute under construction. The standard rule that applies to taxing statutes has been that any ambiguity in the statute should be construed "against the government and in favor of the taxpayer."¹⁰⁶ The policy behind this rule has been that taxation is a creature of legislation, and thus, the meaning of statutes should not be extended "beyond the clear impact of the language used."¹⁰⁷

This rule is tempered by the realistic notion that tax statutes are intended to generate revenue.¹⁰⁸ In line with that notion, construction of statutes defining income are construed liberally to tax all possible sources of revenue.¹⁰⁹ Deductions and exemptions, provided by legislative grace, have been construed narrowly to prevent the escape of legitimate revenue.¹¹⁰ However, courts often apply the rule that ambiguity in taxing statutes be construed "against the government and in favor of the taxpayer"¹¹¹ when interpreting statutes of limitation.¹¹² This is

102. *Id.* § 3.07.

103. *Id.* § 3.01.

104. *Id.*

105. *Id.* § 3.47.

106. 3A NORMAN J. SINGER, SUTHERLAND'S STATUTORY CONSTRUCTION, § 66.01 (5th ed. 1992). "It is a settled rule that tax laws are to be strictly construed against the state and in favor of the taxpayer." *Id.*; see also MERTENS, *supra* note 99, § 3.01. But see MERTENS, *supra* note 99, § 57.03, which notes a trend toward the position that "statutes of limitations barring assessment and collection of taxes justly due and unpaid receives a strict construction in favor of the government."

107. See 3A SINGER, *supra* note 106, § 66.01 (citing *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93-94 (1934)); see also MERTENS, *supra* note 99, § 3.32.

108. MERTENS, *supra* note 99, § 3.47.

109. *Id.*

110. *Id.* §§ 3.49 & 3.50.

111. *Id.* § 3.31 (citing *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93-94 (1934)).

112. See *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927). But see MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE, § 5.01 (2d ed. 1991). Saltzman states: "Statutes of limitations on assessment and collection are construed strictly in favor of the government, because, as the Supreme Court has said, 'the

counter to the normal rule applied when interpreting nontax statutes, which is that "limitations upon action by the United States are construed strictly in favor of the government."¹¹³

However, in 1984, the Supreme Court decided the case of *Badaracco v. Commissioner*.¹¹⁴ In *Badaracco*, the Court clearly extended the general rule that statutes of limitation are to be construed strictly in favor of the government when interpreting ambiguous tax statutes.¹¹⁵ Since then, courts at all levels, including the Tax Court, have cited *Badaracco* when construing statutes of limitation for tax statutes strictly in favor of the government.¹¹⁶

One problem with the rule adopted by the Supreme Court and other courts that have followed *Badaracco* is that the rule relies on the Supreme Court case *Dupont de Nemours & Company v. Davis*.¹¹⁷ *Dupont* was not a tax case, rather it involved a suit by a railroad against the United States to recover demurrage charges that accrued on a shipment made by the railroad.¹¹⁸ Because *Dupont* is not a tax case, the Supreme Court's reliance on *Dupont* is suspect, especially considering the existence of a line of authority which offers a rule counter to the one adopted by the Supreme Court in *Badaracco*.¹¹⁹ The issue of how ambiguity in tax statutes is to be construed in light of

public interest should not be prejudiced by the default or negligence of public officers." *Id.* (citing *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927)). However, the *Bowers* court continued by stating: "The provision is part of a taxing statute, and such laws are to be interpreted liberally in favor of the taxpayers." *Bowers*, 273 U.S. at 350. The *Bowers* court applied the rule that, for taxing statutes, the statutes of limitation should be "interpreted liberally in favor of the taxpayers" in deciding the outcome of that case. *Id.* It seems the *Bowers* court took notice of the general rule that the construction of statutes of limitation should be construed in favor of the government and then modified or created an exception to this rule when applying the statute of limitations for tax statutes. See *Dupont de Nemours & Co. v. Davis*, 264 U.S. 456, 468 (1924).

113. MERTENS, *supra* note 99, § 3.55.

114. 464 U.S. 386 (1984).

115. *Id.*

116. See, e.g., *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990). But see *Larotonda v. Commissioner*, 89 T.C. 287, 292 (1987) (citing *Stockholms Enskilda Bank*, 293 U.S. at 93-94, with approval and stating that "doubts are to be resolved against the government and in favor of the taxpayer").

117. *Badaracco*, 464 U.S. at 391-92 (citing *Dupont de Nemours & Co. v. Davis*, 264 U.S. 456, 458 (1924)).

118. *Dupont*, 264 U.S. at 459.

119. See *supra* notes 111-12 and accompanying text.

*Badaracco*¹²⁰ is a vast issue beyond the scope of this article. Furthermore, an examination of the congressional intent derived from the statutory language and legislative history of section 6037 may eliminate the need to consider which rule of construction for ambiguous statutes should be applied.¹²¹

III. THE SECTION 6501 STATUTE OF LIMITATIONS AND THE RETURNS REQUIRED BY SECTIONS 6012 AND 6037.

A. Overview

If the unified assessment provisions of the Code do not apply,¹²² then the statute of limitations set forth in code section 6501(a) governs the Service's ability to assess tax against the S corporation.¹²³ Section 6501(a) provides that the three year statute of limitations commences

120. *Badaracco*, 464 U.S. at 391-92.

121. See *infra* notes 122-84 and accompanying text.

122. The two possible statutes of limitation on tax return assessments that could apply to an S corporation are § 6501(a) and § 6229(a). Section 6229(a), which is part of the unified assessment provisions for partnerships, was made applicable to S corporations with the passage of Public Law 97-354. See Subchapter S Revisions Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, 1697 (1982). Section 6229(a) provides that the statute of limitations will begin to run with the filing of the S corporation return. See I.R.C. § 6229(a) (1993). Courts have consistently interpreted section 6229(a) as preventing an assessment on the shareholder's return (or partner's return) after the statute of limitations on the S corporation return (or partnership return) has expired. See, e.g., *Amesbury Apartments Ltd. v. Commissioner*, 95 T.C. 227 (1990).

The unified assessment provisions must be applied to all S corporation returns filed after the effective date of their enactment. See, e.g., *Sparks v. Commissioner*, 87 T.C. 1279 (1987). However, there are two major exceptions to the application of the unified assessment provisions. The first exception is by notice. See I.R.C. § 6231(b) (1993). Exception by notice occurs when the Service sends the taxpayer a notice stating that all S corporation items will be treated as individual items. *Id.* The second exception is the small business exception. In 1987, the Service issued Temporary Treasury Regulation 301.6241-1T(c), which states that S corporations with 5 or fewer shareholders are excepted from the unified assessment provisions. Prior to the promulgation of the treasury regulation, the parameters of the small business exception had been litigated. For purposes of this article, it is assumed that the unified assessment provisions do not apply.

123. I.R.C. § 6501(a) (1993). Section 6501(a) states:

Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any times after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expirations of such period.

Id.

with the filing of a "return."¹²⁴ Generally, pursuant to section 6012(a)(2), a corporation is required to file a return.¹²⁵ An S corporation that is not required to file a return pursuant to section 6012(a)(2) is required to file a return pursuant to code section 6037(a).¹²⁶ The Service takes the position that an S corporation return filed pursuant to section 6037(a) is not a return for purposes of section 6501(a), and thus does not start the running of the section 6501 statute of limitations.¹²⁷ To examine the interaction of code sections 6037, 6012, and 6501 as they apply to S corporations, it is useful to look first at how these sections apply to C corporations.

B. The Section 6012 Return Requirement

1. C Corporations

Pursuant to code section 6012, individuals, corporations, estates, and trusts must file a tax return.¹²⁸ Specifically, section 6012(a)(2), as it is relevant to corporations, states that "[r]eturns with respect to income taxes under subtitle A shall be made by the following: . . . (2) Every corporation subject to taxation under subtitle A."¹²⁹ When a corporation files a timely return pursuant to section 6012(a)(2), it is deemed to have filed a return for section 6501(a) purposes and the Service has three years from the date this return is filed to make assessments against the corporation. The Commissioner and the taxpayer may ex-

124. *Id.*

125. *Id.* § 6012(a)(2). See *infra* text accompanying note 129.

126. I.R.C. § 6037(a) (1993). For the text of § 6037(a), see *infra* text accompanying note 140.

127. See, e.g., *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990).

128. I.R.C. § 6012 (1993). Section 6012 states in relevant part:

(a) GENERAL RULE.—Returns with respect to income taxes under subtitle A shall be made by the following:

(1)(a) Every individual having for the taxable year gross income which equals or exceeds the exemptions amount . . .

(2) Every corporation subject to taxation under subtitle A;

(3) Every estate the gross income of which for the taxable year is \$600 or more.

(4) Every trust having for the taxable year any taxable income, or having gross income of \$600 or over, regardless of the amount of taxable income . . .

Id.

129. *Id.* § 6012(a)(2).

tend the statute of limitations by mutual agreement.¹³⁰ If this extension agreement is not made, however, the Service is barred from assessing tax against the corporation three years after the return is filed.¹³¹

2. S Corporations

An S corporation, which is not usually a tax paying entity,¹³² incurs tax liability at the corporate level in only a few circumstances. The Code levies a corporate tax on an S corporation for built-in gains on the appreciated assets of the corporation at the time of the S election,¹³³ for excessive passive investment income,¹³⁴ and for LIFO recap-

130. *Id.* § 6501(c)(4). Section 6501(c)(4), which states:

Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

Id.

131. *Id.* § 6501(a). See *supra* note 123 for text.

132. I.R.C. § 1363(a) (1993). Section 1363(a) states: "Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter." *Id.*

133. *Id.* § 1374(a). Section 1374 provides: "If for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation for such taxable year." *Id.*

Section 1374(a) affects C corporations that have made the S election. Often a C corporation will depreciate assets resulting in their fair market value being considerably above their tax base. Congress thought that some corporations may try to avoid or defer the payment of tax on the large gains that would result from the sale of those assets by making the S election. Thus this tax could be avoided at the corporate level, because, absent this section, a liquidating distribution of an asset is not taxable to a corporation after the S election. 2 EDWIN T. HOOD & JOHN J. MYLAN, FEDERAL TAXATION OF CLOSE CORPORATIONS, § 24.22 (1991).

134. I.R.C. § 1375(a) (1993). Section 1375(a) states:

If for the taxable year an S corporation has—

(1) subchapter C earnings and profits at the close of such taxable year,
and

(2) gross receipts more than 25 percent of which are passive investment income,

then there is hereby imposed a tax on the income of such corporation for such taxable year. Such tax shall be computed by multiplying the excess net passive income by the highest rate of tax specified in section 11(b).

Id.

Section 1375(a) also applies to C corporations that have made the S election. Its purpose is to force corporations that have significant passive investment income to pay

ture.¹³⁶ It is important to note that the sections that impose the tax for these items are in Subtitle A of the Code. Thus, an S corporation that is required to pay tax under one of these provisions is: (1) a corporation and (2) subject to taxation under Subtitle A. The language of 6012(a)(2) demands that the S corporation file a tax return.

Any return filed by a corporation pursuant to section 6012(a)(2) is a "return" under section 6501(a).¹³⁶ The filing of that "return" starts a three year statute of limitations period after which the Service may not make any assessments of tax.¹³⁷ Thus, when the S corporation incurs tax liability at the corporate level, the S corporation's return is the return that starts the statute of limitations running.¹³⁸

C. The Section 6037 Return Requirement

An S corporation that is not subject to taxation under Subtitle A is still required to file a tax return pursuant to code section 6037(a),¹³⁹

out any retained earnings that the corporation has left from when it was a C corporation. 2 HOOD & MYLAN, *supra* note 133, § 24:24.

135. I.R.C. § 1363(d)(1) (1993). Section 1363(d)(1) states that if:

(A) an S corporation was a C corporation for the last taxable year before the first taxable year for which the election under section 1362(a) was effective, and

(B) the corporation inventoried goods under the LIFO method for such last taxable year,

the LIFO recapture amount shall be included in the gross income of the corporation for such last taxable year (and appropriate adjustment to the basis of inventory shall be made to take into account the amount included in gross income under this paragraph).

Id.

If a C corporation that makes an S election uses the last in, first out (LIFO) accounting method for its inventory, it must change to a first in, first out (FIFO) accounting method. This change in accounting methods may increase the inventory's balance sheet value. The S corporation is required to pay tax on this increase in "book" value. HOOD & MYLAN, *supra* note 133, § 24:25.

136. See *supra* notes 128-31 and accompanying text.

137. I.R.C. § 6501(a) (1993). See *supra* note 123 for text.

138. The Tax Court opinion in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), concedes that the return of an S corporation that owes tax at the corporate level is a return for purposes of section 6501(a). *Id.* at 868. This means that for an S corporation that owes tax at the corporate level, the corporate return will be the return from which the statute of limitations is measured. See also *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992).

139. I.R.C. § 6037(a). Section 6037 also applies to S corporations that are subject to

which states:

Every S corporation shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, each shareholder's pro rata share of each item of the corporation for the taxable year, and such other information, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary may by forms and regulations subscribe. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.¹⁴⁰

The second sentence of section 6037(a) clearly states that any return filed pursuant to that section shall be treated as a return filed by the corporation under section 6012. As noted earlier,¹⁴¹ any corporation, including an S corporation, that files a return pursuant to section 6012 has filed a return for purposes of section 6501(a), and therefore, the filing of that return starts the statute of limitations period.

It is instructive to compare the language of code section 6037(a), which requires an S corporation to file a tax return, with section 6031, which requires a partnership to file a return, because S corporation returns are often compared to partnership returns.¹⁴² The first sentence of both sections requires the business organization to file a return stating the items of income, deductions, and credits. As many courts have noted, however, the second sentence of section 6037(a) distinguishes the S corporation return from the partnership return.¹⁴³ The second sentence

taxation and are therefore required to file returns under § 6012, because § 6037 is applicable to "[e]very S corporation." *Id.* However, S corporations that owe tax at the corporate level are required to file a corporate tax return pursuant to § 6012, thus making the additional requirements of § 6037 beyond those required by § 6012 presumably supplemental. *See supra* notes 132-38 and accompanying text.

140. I.R.C. § 6037(a) (1993).

141. *See supra* notes 128-38 and accompanying text.

142. I.R.C. § 6031(a) (1993). Section 6031(a) states:

Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in taxable income if distributed and the amount of the distributive share of each individual.

Id.

143. Courts, including the Tax Court, have recognized the difference in the statutory language of §§ 6037 and 6031. *See Siben v. Commissioner*, 930 F.2d 1034 (2d Cir.), *cert. denied*, 112 S. Ct. 429 (1991); *Stahl v. Commissioner*, 96 T.C. 798 (1991).

of section 6037(a) states that “[a]ny return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.”¹⁴⁴ There is no comparable language in section 6031 which would be applicable to the return filed by a partnership.¹⁴⁵ Thus, it follows that to give effect to the second sentence of section 6037(a), an S corporation return should be treated differently than the mere “informational” return of a partnership.¹⁴⁶ The language of section 6037(a) states that the S corporation return should be treated as a return filed by a corporation under section 6012.

Since the return filed by an S corporation pursuant to section 6037(a) is to be treated like a return filed by a corporation under section 6012, the return of an S corporation that does not owe tax at the corporate level must be considered a return for section 6501(a) purposes. If the S corporation return is a return for section 6501(a) purposes, the S corporation’s return initiates the three year statute of limitations period.¹⁴⁷ Thus, the S corporation’s return is not merely an “informational return” like the return filed by a partnership, but, instead, it is a return that initiates the running of the section 6501(a) statute of limitations period.

Proponents of the position that section 6037 returns are not returns for purposes of section 6501(a) often cite treasury regulation section 1.6037-1(c), which states:

The return on Form 1120-S will be treated as a return filed by the corporation under section 6012, relating to persons required to make returns of income, for purposes of the provisions of chapter 66 of the Code, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, chapter 1 of the Code, will run from the date of filing the return under section 6037, or from the date prescribed for filing such return, whichever is the later.¹⁴⁸

This regulation has been used to reinforce the position that an S corporation return filed pursuant to section 6037(a) will be treated as a return that starts the section 6501(a) statute of limitations on assessment only if the corporation’s S election is later determined to be invalid.¹⁴⁹ The reg-

144. I.R.C. § 6037(a) (1993). See *supra* text accompanying note 140 for text.

145. I.R.C. § 6031(a) (1993). See *supra* note 142 for text.

146. See *Siben*, 930 F.2d at 1037; *Stahl*, 96 T.C. at 801-02.

147. See *Kelley v. Commissioner*, 877 F.2d 756, 758-59 (9th Cir. 1989).

148. Treas. Reg. 1.6037-1(c) (as amended in 1969).

149. See, e.g., *Fehlhaber v. Commissioner*, 94 T.C. 863, 867 (1990), *aff’d*, 954 F.2d 653 (11th Cir. 1992).

ulation tracks the language of section 6037's legislative history, which will be discussed more fully later.¹⁵⁰ Briefly, however, the regulation does not provide for the restrictions that are claimed. It clearly states that S corporation returns filed under section 6037(a) will be treated as returns filed under 6012.¹⁵¹ As shown by the above discussion, corporate returns filed pursuant to section 6012 are returns for purposes of the section 6501(a) statute of limitations.¹⁵²

Even if the regulation can be construed to support the position that returns filed pursuant to section 6037(a) start the statute of limitations only if it is later determined that the corporation's S election was invalid, that interpretation directly conflicts with the language of section 6037(a), which refers to "[a]ny return filed pursuant to this section."¹⁵³ There is no support in the statutory language of section 6037 for the limitation claimed to be found in the regulation or a limitation of any other kind. A regulation that conflicts with the language of Congress can not be enforced.¹⁵⁴

In *Fehlhaber*, the Tax Court held that it was not bound to apply the literal phrasing of a statute when it would lead to an "absurd result."¹⁵⁵ Though this standard has enough ambiguity to allow a court to exercise result oriented jurisprudence, the interpretation of the interaction of sections 6012, 6037, and 6501(a) as presented above could not be considered "absurd." The application of this standard is more logical given the administrative difficulties and statutory inconsistencies that result from treating some S corporation returns as returns for section 6501(a) purposes and not others. Moreover, the interpretation presented above looks even more reasonable when viewed with other Internal Revenue Code provisions related to the taxation of S corporations.

Section 1371(a)(1) states a general rule that is relevant to the dispute currently under discussion: "Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders."¹⁵⁶ This section raises a presumption that the rules that apply to C corporations shall also apply to S corporations. While it might be argued that this presumption is limited to the rules in Subchapter C, the language "[e]xcept as

150. See *infra* notes 159-84 and accompanying text.

151. Treas. Reg. 1.6037-1(c) (as amended in 1969). See *supra* text accompanying note 148.

152. See *supra* notes 128-31 and accompanying text.

153. See I.R.C. § 6037(a) (1993). See *supra* text accompanying note 140.

154. MERTENS, *supra* note 99, § 1.11.

155. *Fehlhaber*, 94 T.C. 863, 866 (1990) (quoting *Commissioner v. Brown*, 380 U.S. 563, 571 (1965)).

156. I.R.C. § 1371(a) (1993).

otherwise provided by this title,"¹⁵⁷ contemplates the presumption covering all of title 26 of the United States Code, which would encompass the whole Internal Revenue Code.

If S corporations are to be treated like C corporations (except where otherwise provided or otherwise inconsistent), it follows that returns filed by S corporations should be treated like returns filed by C corporations. Since the return filed by a C corporation is a return that triggers limitations period, the S corporation return should also be treated as a return that triggers the running of the section 6501(a) limitations period. If the S corporation return is treated as a return that initiates the running of the section 6501(a) limitations period, the Service is barred from making assessments attributable to S corporation items reported on a shareholder's individual return after the statute of limitations period for the S corporation's return has expired.

There are some who might argue that section 6037 is a provision that overturns the presumption or inference that S corporations are to be treated as C corporations. Congress, however, is very explicit about creating an exception to the general inference of section 1371(a)(1). For example, section 1372(a)(1) states: "For purposes of applying the provisions of this subtitle which relate to employee fringe benefits the S corporation shall be treated as a partnership"¹⁵⁸ The language of section 6037(a) does not contain the specific language of an exception, such as the one that appears in section 1372(a)(1). Instead, section 6037(a) affirms the inference that S corporations are to be treated as C corporations when it states that any return filed under this section shall be treated as a return filed by a corporation pursuant to section 6012. To read section 6037 as making the S corporation's return a mere "informational return," similar to the return filed by a partnership, defies both the language of section 6037(a) and the inference raised by code section 1371(a).

157. *Id.*

158. I.R.C. § 1372(a) (1993). Section 1372(a) states: "For purposes of applying the provisions of this subtitle which relate to employee fringe benefits—(1) the S-corporation shall be treated as a partnership, and (2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership." *Id.*

IV. THE LEGISLATIVE HISTORY

A. Overview

As noted above, if a court concludes that the statutory language is ambiguous, the court should examine the intent of Congress as evidenced by the legislative history.¹⁶⁰ Legislative intent, however, should be examined only if the meaning of a law is ambiguous.¹⁶⁰ If the statutory language is unambiguous, it should be followed.¹⁶¹ The previous discussion has shown that a proper analysis of the relevant code sections does not require a court to examine the legislative history because the language of the statute is clear.¹⁶² Although such an examination is not required, a look at the legislative history provides support for the position that section 6037 returns should be treated as returns for section 6501(a) purposes.¹⁶³

The S corporation was created by Congress to make the choice of entity for a business enterprise tax neutral.¹⁶⁴ Before the S corporation provisions were enacted, the choice of entity for a business was either a sole proprietorship, a partnership, or a corporation. If there were two or more people working as co-managers in the business enterprise, the choice of entity was quickly pared to that of a partnership or a corporation.¹⁶⁵ The individual/owners obtained the advantages of limited liability under state law only if the business was operated as a corporation. However, they also incurred the disadvantage of two levels of taxation: one at the corporate level on corporate income and a second tax paid by the shareholder when the corporate earnings were distributed as dividends.¹⁶⁶ If the business chose to become a partnership, it avoided the two levels of taxation but did not get the advantage of limited liability under state law.

With some sense that the choice of entity should not be driven so strongly by tax considerations, Congress created a new kind of entity, the S corporation.¹⁶⁷ The S corporation is a business that is incorporated under the laws of a state, thereby gaining the advantage of limited liability, but is taxed as a pass-through entity.¹⁶⁸ A pass-through entity is

159. See *supra* notes 99-104 and accompanying text.

160. See *supra* notes 101-03 and accompanying text.

161. See *supra* notes 99-104 and accompanying text.

162. See *supra* notes 122-58 and accompanying text.

163. See *infra* notes 164-84 and accompanying text.

164. S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

165. See *id.*

166. See *supra* notes 41-44 and accompanying text.

167. Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1606 (codified as amended in scattered sections of 26 U.S.C.).

168. *Id.*

not taxed at the entity level.¹⁶⁹ Rather, the income, deductions and credits of the corporation are "passed through" to the shareholder and computed as part of his individual tax liability.¹⁷⁰ This arrangement avoids the disadvantage of double taxation that occurs when a business operates as a C corporation.

B. The Legislative History of Section 6037

At the time the legislation creating the S corporation was enacted, the S corporation did not pay tax at the entity level.¹⁷¹ There was, therefore, little apparent need for it to file a tax return. However, when Congress enacted the S corporation provisions, it also enacted section 6037(a), which requires the S corporation to file a tax return.¹⁷² The following passage from the Senate Report describes the legislation and the purpose for requiring an S corporation to file a return:

Notwithstanding the fact that an electing small-business corporation is not subject to the tax imposed by chapter 1 of the 1954 Code, such corporation must make a return for each taxable year in accordance with new section 6037 as added by subsection (c) of section 68 of the bill. Such return will be considered as a return filed under section 6012 for purposes of the provisions of chapter 66, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, will run from the date of filing of the return required under the new section 6037.¹⁷³

Proponents of the position that S corporation returns do not trigger the running of the limitations period cite this paragraph of legislative history.¹⁷⁴ They interpret this paragraph as stating that the S corporation return initiates the running of the statute of limitations only if the S election is later deemed invalid.¹⁷⁵

This interpretation of the legislative history does not adequately explain the use of the language "Thus, for example" that starts the last

169. See *supra* notes 28-34 and accompanying text.

170. I.R.C. § 1366(a) (1993). See *supra* note 33 for text.

171. With the enactment of Pub. L. No. 89-398, 80 Stat. 11 (1966), S corporations were first required to pay tax at the corporate level.

172. Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1606 (codified as amended in scattered sections of 26 U.S.C.).

173. S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958), *reprinted in* 1958 U.S.C.A.N. 4791, 5014.

174. See, e.g., *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992).

175. *Id.* at 866.

sentence of the paragraph. One example is not indicative of an exhaustive list of all the situations meant to be covered by the statute. Why, then, would Congress use the language "Thus, for example" in the legislative history of section 6037? What other examples did Congress have in mind?

The scope of section 6037 at the time of its enactment was very limited. It required S corporations to file returns. The only business entities that would file S corporation returns were corporations that validly made an S election or C corporations that incorrectly filed an S corporation return pursuant to an S election that was later determined to be invalid. Thus, the only other situation Congress could have contemplated, other than the situation included in the legislative history of section 6037, is that of an S corporation that files an S corporation return pursuant to a valid election. By using the language "Thus, for example," the legislative history includes, by implication, the situation of an S corporation that files an S corporation return pursuant to a valid election. Therefore, the legislative history confirms that S corporation returns are returns that start the statute of limitations running.

If Congress intended the S corporation return to be considered a corporate return for statute of limitations purposes only in the event of an invalid subchapter S election, it could have expressed that intention clearly in the statute itself. Instead, the statutory language enacted by Congress uses the broad language, "[a]ny return filed under this section shall be treated as a return filed under 6012 for purposes of Article 66 (relating to limitations)."¹⁷⁶ The legislative history plainly states that an S corporation return "will be considered as a return filed under section 6012 for purposes of the provision of Chapter 66, relating to limitations."¹⁷⁷ The "example" given in the legislative history states that the period of limitations on assessment "will run from the date of filing of the return required under the new section 6037."¹⁷⁸ Considering the language of the statute and the legislative history, a better reading of section 6037 and its legislative history would be: all returns filed under section 6037 should be considered as filed under 6012 for limitations purposes. One example of where the treatment of the return filed pursuant to section 6037 might become significant is when a corporation's subchapter S election is later deemed invalid.

It is possible that the language "Thus, for example" was used in the legislative history for expediency. The passage of voluminous amounts of legislation could lead to a hasty and unartful drafting of the legislative

176. I.R.C. § 6037(a) (1993). See *supra* text accompanying note 140 for text.

177. S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted in 1958 U.S.C.C.A.N. 4791, 5014.

178. *Id.*

history. When drafting the legislative history of section 6037, Congress may not have contemplated an alternative example, but did not wish to exclude situations they had failed to anticipate. This interpretation, however, is highly speculative and should not be relied upon in well reasoned analysis.

It might be somewhat persuasive that section 6037 is found in the section titled "Information returns," but section 7806(b) says that section titles should be ignored.¹⁷⁹ It could be argued that Congress enacted the section 6037 return requirement for S corporations as the equivalent of the section 6031 return requirement for partnerships. This would totally ignore the second sentence of section 6037(a) which has no analogue in the partnership section, section 6031.¹⁸⁰ Even the Tax Court has recently taken notice of the difference between sections 6031 and 6037.¹⁸¹

C. *The Legislative History of the Unified Assessment Provisions*

Another section of legislative history that indirectly discusses section 6037 is the Senate Report on the unified assessment provisions.¹⁸² At the time the unified assessment provisions were enacted, Congress observed, "[u]nder present law, . . . [s]tatutes of limitations apply at the individual level, based on the returns filed by the individual."¹⁸³ While it seems that this statement strongly supports the position that S corporation returns filed pursuant to section 6037 (the then-current law re-

179. I.R.C. § 7806(b) (1993). Section 7806(b) states:

No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title, nor shall any table of contents, table of cross references, or similar outline, analysis, or descriptive matter relating to the contents of this title be given any legal effect. The preceding sentence also applies to the sidenotes and ancillary tables contained in the various prints of this Act before its enactment into law.

Id.

180. *See id.* § 6037(a). *See supra* text accompanying note 140 for text. *Compare* I.R.C. § 6031(a). *See supra* note 142 for text. *See also* *Siben v. Commissioner*, 930 F.2d 1034, 1037 (2d Cir. 1989), *cert. denied*, 112 S. Ct. 429 (1991) (denoting the fact that the second sentence of § 6037 has no analog in § 6031 and thus the statutes should be applied differently); *Stahl v. Commissioner*, 96 T.C. 798 (1991).

181. *See Stahl*, 96 T.C. 798 (citing *Siben v. Commissioner*, 930 F.2d 1034 (2d Cir. 1989)).

182. S. REP. NO. 640, 97th Cong., 2d Sess. 25 (1982), *reprinted in* 1982 U.S.C.A.N. 3253, 3275.

183. *Id.*

ferred to in the passage) are not returns for purposes of section 6501(a), it would be ill-advised to put great weight on the interpretation Congress made in 1982.¹⁸⁴

The purpose of the legislative history for the unified assessment provisions is to provide a backdrop for the enactment of code sections 6241-6245, which set out the unified assessment procedures for the determination of S corporation tax liability at the corporate level. The paragraph of legislative history cited is not the result of a detailed analysis by Congress on the current state of the law. The language does not address the major sections at issue, but instead cuts a broad swath through the law for purposes of comparison. Additionally, this language is of limited value since it does not express the intent of Congress regarding the original enactment of section 6037. The expression of congressional intent for the original enactment of a code section should be more persuasive than a summary treatment of the law in a congressional enactment of different code sections twenty-four years later.

V. ANALYSIS OF THE COURT OPINIONS

A. *The Return Requirement of Sections 6012 and 6037*¹⁸⁵

1. S Corporations That Owe Tax

The Eleventh, Fifth, and Second Circuits affirmed the Tax Court's conclusion that the S corporation return starts the statute of limitations period running only when the S corporation is liable for tax at the corporate level.¹⁸⁶ The courts' conclusions are derived from an examination of the statutory language of section 6037(a).¹⁸⁷ The circuit courts of appeal and the Tax Court interpret the second sentence of section 6037(a), which states that returns filed pursuant to section 6037 are to be treated as returns filed under section 6012, as affecting only those S corporations that become liable for tax at the corporate level.¹⁸⁸

The Supreme Court's position concerning the statute of limitations period for S corporations that owe tax at the corporate level is unclear.¹⁸⁹

184. *Bufferd v. Commissioner*, 113 S. Ct. 927, 931-32 n.10 (1993).

185. For a general discussion, see *supra* notes 122-58 and accompanying text.

186. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992), *cert. denied*, 113 S. Ct. 1251 (1993); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992), *aff'g* 94 T.C. 863 (1990); *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992), *aff'g* 61 T.C.M. (CCH) 2410 (1991).

187. *Green*, 963 F.2d at 790; *Fehlhaber*, 954 F.2d at 656; *Bufferd*, 952 F.2d at 677.

188. *Green*, 963 F.2d at 790; *Fehlhaber*, 954 F.2d at 656; *Bufferd*, 952 F.2d at 677.

189. *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993), *aff'g* 952 F.2d 675 (2d Cir. 1992).

In the recent *Bufferd* opinion, the Supreme Court wrote, "[T]he errors on the corporate return did not and could not affect the tax liability of the corporation, and hence the Commissioner could only assess a deficiency against the stockholder/taxpayer whose return claimed the benefit of the errors."¹⁹⁰ This sentence may be interpreted narrowly or broadly.

The narrow interpretation focuses on the language "the errors on the corporate return did not and could not affect the tax liability of the corporation" ¹⁹¹ If the S corporation owed tax at the corporate level, then this language leaves open the possibility that when assessments could be made against the S corporation, the statute of limitations begins to run with the corporate return. Taxpayers, who are shareholders in an S corporation, involved in future cases in which the S corporation owed tax could use this language to distinguish and, thereby limit, the application of the Supreme Court opinion in *Bufferd*.

The broad interpretation of the above quoted language¹⁹² is that an assessment can only be made against the taxpayer who is to pay the tax. Therefore, even if the S corporation owes tax at the corporate level, only those adjustments to the S corporation return that affect the corporation's tax liability are barred by the expiration of the limitations period for the corporate return. If the adjustment does not affect the tax liability of the corporation, only the expiration of the statute of limitations for the shareholder's return reporting the S corporation flow-through tax items would bar the assessment.

The broad interpretation begs the question of whether the statute of limitations bars an adjustment to an entity's return if that adjustment does not affect the tax liability of that entity. If the Supreme Court adopts the broad interpretation, it would provide the government with the only analysis which unqualifiedly supports the government's position in the cases discussed in this article. Under the broad interpretation, the statute of limitations for S corporations that owe tax begins to run with the filing of the S corporation return only for the tax items that affect the S corporation's tax liability. For the items that flow-through to the shareholder's return, the shareholder's return would be the return which initiates the statute of limitations regardless of whether the S corporation is liable for tax.

What remains to be answered after the Supreme Court opinion in

190. *Id.* at 930.

191. *Id.*

192. *See supra* text accompanying note 190.

Bufferd is whether the law should be applied to reflect the broad interpretation or the narrow interpretation of the Supreme Court's language. The implications of applying the broad interpretation of the *Bufferd* language are discussed more thoroughly later in this article.¹⁹³ However, the case for the broad interpretation is weakened by the fact that it is directly counter to the conclusions of the Tax Court and at least four circuit courts of appeal regarding S corporations that owe tax at the corporate level.¹⁹⁴ Considering the ambiguity of the Supreme Court's language in *Bufferd*, the better interpretation is the one that is most consistent with the clearly articulated position of the other courts, especially in light of the fact that the specific holding of the Supreme Court in *Bufferd* concerned only the application of the statute of limitations to the S corporation's shareholders who did not owe tax at the corporate level.¹⁹⁵

Further support for the narrow interpretation is found in other passages of the Supreme Court opinion. The Supreme Court cites the Tax Court opinion of *Lardas v. Commissioner*¹⁹⁶ in a footnote.¹⁹⁷ The citation from *Lardas* cites the Tax Court opinion in *Fehlhaber*.¹⁹⁸ In *Fehlhaber*, the Tax Court concedes that if the S corporation owed income tax at the corporate level, the statute of limitations would be triggered by the filing of the S corporation's return.¹⁹⁹ In addition, the Supreme Court suggests that when the S corporation is subject to the capital gains tax, the statute of limitations for assessing that tax begins with the filing of the corporation's return.²⁰⁰ While some of the language of *Bufferd* provides support for possible future Supreme Court decisions adopting the broad interpretation, currently the Supreme Court's opinion in *Bufferd* should be read as adopting the narrow interpretation of the language cited above.²⁰¹ The narrow interpretation of the language produces consistency among the Court's opinion, the opinion of the Tax Court, and the opinion of four of the circuit courts of appeal.

The analysis used by the circuit courts of appeal and the Tax Court for

193. See *infra* notes 306-31 and accompanying text.

194. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992), *cert. denied*, 113 S. Ct. 1251 (1993); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992), *aff'd* 94 T.C. 863 (1990); *Fendell v. Commissioner*, 906 F.2d 362 (8th Cir. 1990); *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989).

195. See *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993), *aff'd* 952 F.2d 675 (2d Cir. 1992).

196. 99 T.C. 490 (1992).

197. *Buffered*, 113 S. Ct. at 932-33 n.11.

198. *Lardas*, 99 T.C. 490 (citing *Fehlhaber v. Commissioner*, 94 T.C. 863, 868 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992)).

199. See *Fehlhaber*, 94 T.C. at 868.

200. *Bufferd*, 113 S. Ct. at 931-32 n.10.

201. See *supra* text accompanying note 190.

S corporations that owe tax, however, has two significant weaknesses. The first weakness is present in the Supreme Court's analysis of S corporations that are subject to the capital gains tax.²⁰² As discussed earlier, an S corporation that is liable for tax at the corporate level would be a corporation that owes tax under the provisions of subtitle A.²⁰³ As such, section 6012(a)(2) requires the S corporation to file a return.²⁰⁴ The suggestion that the second sentence of section 6037(a) converts S corporation returns to section 6012 returns in the event that the S corporation owes tax at the corporate level makes the second sentence of section 6037(a) surplus. A return filed by an S corporation that owes tax meets the definition of a section 6012 return without the language contained in the second sentence of section 6037(a).²⁰⁵ No purpose would be served by including language in a statute that has the same effect as language in a pre-existing statute.

Secondly, the circuit and Tax Courts' reasoning is undermined by the fact that S corporations were not liable for any corporate level tax at the time section 6037 was enacted.²⁰⁶ Since S corporations did not pay a corporate level tax when section 6037 was enacted, interpreting the second sentence of section 6037(a) as applying only when an S corporation owes tax at the corporate level ignores the congressional intent of this code section.²⁰⁷ The interpretation of section 6037(a) that these courts adopt, as it pertains to S corporations that owe tax at the corporate level, fails to give effect either to the statutory language of section 6037(a) or the congressional intent behind the statutes' enactment.

2. S Corporations That Do Not Owe Tax at the Corporation Level

a. Overview

The courts holdings that the statute of limitations for the S corporation tax items begins with the filing of the shareholder's return reframe the main argument. The opinions discuss whether the S corporation return can be a "return" for purposes of section 6501(a).²⁰⁸ The courts that

202. See *Bufferd*, 113 S. Ct. at 931-32 n.10.

203. See *supra* notes 132-38 and accompanying text.

204. I.R.C. § 6012(a)(2) (1993). See *supra* text accompanying note 129 for text.

205. See *supra* notes 132-38 and accompanying text.

206. S corporations were first required to pay tax at the corporate level with the enactment of Pub. L. No. 89-398, 80 Stat. 111 (1966).

207. See *supra* notes 171-81 and accompanying text.

208. *Bufferd v. Commissioner*, 113 S. Ct. 927, 930 (1993), *aff'g* 952 F.2d 675, 677

have ruled against the taxpayer focus on the fact that the S corporation's return is a mere "informational return," which does not result in tax liability to the S corporation.²⁰⁹

In finding that the S corporation return does not start the section 6501(a) limitation period, these courts conclude that the S corporation return does not meet the traditional common law definition of a "return" for section 6501(a) purposes.²¹⁰ Pursuant to that body of case law, there is a general consensus that the return must contain the information necessary to calculate the taxpayer's tax liability before it will be considered a "return" within the meaning of section 6501(a).²¹¹ Because the S corporation return lacks vital information necessary for calculating the shareholder's resulting tax liability, these courts reason that the S corporation return does not trigger the section 6501(a) statute of limitation for assessments against the shareholder.²¹² The Eleventh Circuit bolstered this analysis by explaining the purpose of the Subchapter S provisions,²¹³ stating that the purpose of Subchapter S was to have a corporation taxed like a partnership.²¹⁴ The court then concluded that it is inconsistent with that intention to treat the S corporation return as a return for section 6501(a) purposes.²¹⁵

The reasoning used by these courts is unsound for several reasons. First, the thrust of the taxpayer's argument is not that the S corporation return meets the common law requirements for a section 6501(a) return. Rather, the argument centers on the interpretation of the language contained in section 6037(a) and whether that language requires a return that might not ordinarily be considered a return for purposes of section 6501(a) to be treated as such.²¹⁶ Therefore, dispositive analysis of the meaning of section 6037(a) should not consider whether the S corporation return meets the requirements found in case law defining a return for section 6501(a) purposes.

Secondly, the concept that an S corporation is taxed like a partnership rather than a C corporation should not control the analysis. Undeniably,

(2d Cir. 1992); *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992), *cert. denied*, 113 S. Ct. 1251 (1993); *Fehlhaber v. Commissioner*, 954 F.2d 653, 655 (11th Cir. 1992), *aff'g* 94 T.C. 863, 868 (1990). *Compare* *Kelley v. Commissioner*, 877 F.2d 756, 759 (9th Cir. 1989).

209. *Green*, 963 F.2d at 788 (citing *Fehlhaber*, 954 F.2d at 656); *see also* *Bufferd*, 113 S. Ct. at 930.

210. *Id.*; *Green*, 963 F.2d at 788; *Fehlhaber*, 954 F.2d at 655.

211. MERTENS, *supra* note 99, § 57.09.

212. *Bufferd*, 113 S. Ct. at 930; *Green*, 963 F.2d at 788; *Fehlhaber*, 954 F.2d at 655.

213. *Fehlhaber*, 954 F.2d at 655.

214. *Id.*

215. *Id.*

216. *See supra* 139-81 and accompanying text.

both S corporations and partnerships are “pass-through entities,” and as such share many characteristics. S corporations, however, have never been taxed under the partnership provisions of subchapter K of the Code.²¹⁷ Differences between the taxation of S corporations and partnerships have existed from the inception of the S corporation to the present Code.²¹⁸ Further, the legislative history relating to the subchapter S provisions does not describe the S corporation as a corporation that is taxed in the same manner as a partnership.²¹⁹ Every reference to the new entity created by that public law refers to an “electing small business.”²²⁰

The language of section 1371(a) is consistent with the concept that the S corporation is not strictly a “corporation taxed like a partnership.” Code section 1371(a) states that the rules for C corporations apply to S corporations unless the application would be inconsistent with the rules of Subchapter S.²²¹ The language of section 6037(a) merely repeats the presumption that the S corporation should be viewed as a C corporation and applies this principle to the act of filing a return. Thus, the Code raises a presumption that the S corporation return is to be treated like the return of a C corporation. The paradigm that the courts use for treating S corporation returns similar to “informational returns” filed by partnerships fails to address these arguments. It would be a mistake to base an interpretation of the rules relating to S corporation returns on a flawed analogy to code sections or taxation theory that applies to partnerships, rather than the statutory language and the intention of Congress relating to S corporations.

b. Interpreting the statutes

In *Kelley v. Commissioner*, the Ninth Circuit began its analysis by looking at the language of section 6037(a).²²² The Ninth Circuit noted

217. See MERTENS, *supra* note 99, §§ 41B.02 & 41B.03.

218. *Id.*

219. See S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

220. *Id.*

221. I.R.C. § 1371(a) (1993). See *supra* text accompanying note 156. The Supreme Court clearly disregards the language of this section when it notes in *Bufferd* that the taxpayer's premise of comparing the statute of limitations of C corporations to S corporations was flawed because “the taxation of C corporations and their stockholders is so markedly different from that of S corporations.” *Bufferd v. Commissioner*, 113 S. Ct. 927, 932 n.11 (1993), *aff'g* 952 F.2d 675 (2d Cir. 1992).

222. 877 F.2d 756, 758 (9th Cir. 1989).

that the plain language of section 6037(a) states that any return filed under section 6037 should, for purposes of the section 6501(a) statute of limitations, be treated as a return filed by a C corporation.²²³ Therefore, the court concluded that the Service may not make assessments relating to the S corporation return or any S corporation tax item reported on the shareholder's return after the expiration of the statute of limitations for the S corporation return.²²⁴ The Ninth Circuit analyzed how this interpretation is both fair and consistent with purposes of the statute of limitations provision.²²⁵

In *Bufferd*, the Supreme Court stated that the language "any return" does not demonstrate that the shareholder's return is brought within the compass of section 6037(a) simply because the tax items are passed through from the corporation's return and reported on the shareholder's return.²²⁶ The Supreme Court further suggested that section 6037(a)'s focus on the return of the S corporation supports the opposite conclusion.²²⁷ The snag in the Supreme Court's analysis, as the taxpayer in *Bufferd* argued, is that the interpretation the Supreme Court gives section 6037 effectively eliminates the second sentence of section 6037(a) from the Code.²²⁸ At the time section 6037(a) was enacted, S corporations did not pay tax at the corporate level.²²⁹ There would have been no purpose for enacting a statute of limitations for assessment on an entity that was never subject to tax unless it was intended to prevent an assessment against the shareholders of that entity on the corporate tax items passed through and reported on the shareholders' returns.²³⁰

The Supreme Court suggested that its interpretation preserves the vitality of section 6037(a) in two ways. First, the Supreme Court stated that, prior to the time S corporations were subject to any corporate level tax, the statute of limitations supplied by section 6037 provided a limited period for the Service to invalidate the S election.²³¹ The taxpayer argued against the Supreme Court's interpretation, noting that if an S election is invalidated, the S corporation return automatically becomes subject to the rules of subchapter C.²³² The Supreme Court countered by

223. *Id.*

224. *Id.*

225. *Id.*

226. *Bufferd v. Commissioner*, 113 S. Ct. 927, 931 (1993), *aff'g* 952 F.2d 675 (2d Cir. 1992).

227. *Id.*

228. *Id.*

229. S corporations were first required to pay tax at the corporate level with the enactment of Pub. L. No. 89-398, 80 Stat. 111 (1966).

230. *See supra* notes 171-81 and accompanying text.

231. *Bufferd*, 113 S. Ct. at 931.

232. *Id.*

stating that "this proposition is hardly self evident."²³³

Although the Supreme Court argued that it is not self evident that a corporation making an invalid S election becomes subject to the rules of subchapter C, this is not a difficult position to defend. S corporations are C corporations that have elected S status.²³⁴ If a corporation's S election is invalidated, it continues to maintain its corporate status, and thus, becomes subject to the rules that normally apply to corporations—the rules of subchapter C.

Section 6012(a)(2) requires that corporations subject to tax under subtitle A file a return.²³⁵ However, the C corporation, with a now invalid S election, has filed a tax return pursuant to section 6037(a) that reports the corporation's "gross income and deductions."²³⁶ The reporting of this data, according to the cases cited by the Supreme Court in *Bufferd*, is the minimum information necessary to constitute a "return" for purposes of section 6501(a) and start the statute of limitations running.²³⁷ Therefore, if the Service invalidates the S election within the three year limitations period, it may determine the tax liability of the C corporation from the return mistakenly filed by the corporation pursuant to section 6037(a). If the Service does not invalidate the S election within the three year limitations period, the Service is still barred from making an assessment of tax against the corporation by the expiration of the statute of limitations period for the corporate return filed pursuant to an invalid S election, even without section 6037(a) of the Code.²³⁸ Thus, this justification used by the Supreme Court to demonstrate how its interpretation maintains the vitality of section 6037 is frail.

The Supreme Court's second justification supporting the position that its interpretation retains some vitality for section 6037(a) is the case of an S corporation that owes a corporate level tax.²³⁹ In a footnote, the Supreme Court noted that without section 6037(a), the Service could ar-

233. *Id.*

234. I.R.C. § 1361(a)(1) (1993). Section 1361(a)(1) states: "For purposes of this title, the term 'S corporation' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year."

Id.

235. *Id.* § 6012(a)(2). *See supra* text accompanying note 129 for text.

236. *See* I.R.C. § 6037(a) (1993). *See supra* text accompanying note 140 for text.

237. *Bufferd*, 113 S. Ct. at 930 (citing *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 188 (1957) (citing *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944))).

238. *See* I.R.C. § 6501(a) (1993). *See supra* note 123 for text.

239. *Bufferd*, 113 S. Ct. at 931-32 n.10.

gue that the statute of limitations for an S corporation subject to the capital gains tax begins to run from the time of filing of the shareholder's return.²⁴⁰ However, an S corporation subject to the capital gains tax would be a corporation subject to taxation under Subtitle A and therefore required to file a tax return under section 6012(a)(2).²⁴¹ Thus, even without section 6037(a), the Service could not successfully argue that the statute of limitations on an S corporation that owed corporate income tax was only triggered upon the filing of the shareholder's return.²⁴²

When discussing S corporations that do not owe corporate income tax, neither the Tax Court, the Eleventh, nor the Second Circuit have analyzed the plain meaning of the statutory language of section 6037(a) in any depth.²⁴³ The Tax Court has suggested that the taxpayer's interpretation of the statutory language, which relies on the Ninth Circuit's opinion in *Kelley*, is "absurd."²⁴⁴ The Eleventh Circuit has suggested that taxpayer's analysis is against "common sense."²⁴⁵ The analysis of the plain language of section 6037(a) is not more extensive than these conclusions.²⁴⁶ Holders of these opinions explain the existence of the second sentence of section 6037(a) by reasoning that the sentence applies only to S corporations that owe tax at the corporate level.²⁴⁷ As suggested above, the rationale for such a position is suspect.²⁴⁸ S corporations that owe tax are required to file returns by section 6012(a)(2) regardless of the section 6037(a) return requirement.²⁴⁹

The Fifth Circuit has focused more on the statutory language of section 6037(a).²⁵⁰ When interpreting the second sentence of section 6037(a), which states that an S corporation return filed pursuant to section 6037 should, for purposes of limitations, be treated as a return filed under section 6012, the Fifth Circuit reasoned that the return filed by the S corporation must be examined in light of the language of section 6012.²⁵¹ Section 6012(a)(2) states that a corporation subject to taxation

240. *Id.*

241. See I.R.C. § 6012(a)(2) (1993). See text accompanying note 129 for text.

242. See *supra* notes 139-58 and accompanying text.

243. See *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992); *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992).

244. See *Fehlhaber*, 94 T.C. at 866.

245. *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992).

246. See *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992); *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992).

247. *Fehlhaber*, 94 T.C. at 868; *Fehlhaber*, 954 F.2d at 656; *Bufferd*, 952 F.2d at 677-78.

248. See *supra* notes 202-07 and accompanying text.

249. See *supra* notes 132-38 and accompanying text.

250. *Green v. Commissioner*, 963 F.2d 783, 790 (5th Cir. 1992).

251. *Id.*

under subtitle A must file a return.²⁵² The Fifth Circuit noted that an S corporation that does not owe tax at the corporate level is not required to file a section 6012 return, and therefore, neither section 6012 nor the second line of section 6037(a) are applicable to an S corporation that does not owe corporate income tax.²⁵³

The implication of the Fifth Circuit's interpretation of section 6037 is that the second sentence of that section applies only to S corporations that owe tax at the corporate level.²⁵⁴ As discussed above, the rationale for such a result is flawed.²⁵⁵ Applying the better interpretation of the interaction between section 6037 and section 6012 developed in this article²⁵⁶ shows how the Fifth Circuit's analysis of section 6037(a) for S corporations that do not owe corporate income tax fails to give effect to the language Congress placed into the Code. Giving effect to the language contained in the second sentence of section 6037(a) contradicts the analysis used by the Fifth Circuit to resolve this dispute.

c. Interpreting the legislative history

Only in response to the Tax Court did the Ninth Circuit examine the legislative history of section 6037.²⁵⁷ Upon this examination, the Ninth Circuit noted that the Tax Court's opinion ignores the language "[f]or example" present in the legislative history.²⁵⁸ The Ninth Circuit reasoned that section 6037 and its accompanying legislative history should be interpreted such that a return filed by an S corporation under section 6037(a) should be treated as a return filed by a corporation under section 6012 for purposes of the section 6501(a) limitations period.²⁵⁹ An example where treating the S corporation return as a return filed by a C corporation would be relevant is the case of an invalid election.²⁶⁰ Such an interpretation bars the Service from making adjustments attributable to the S corporation tax items, reported on the S corporation's return or on the returns of its shareholders, after the limitations period has ex-

252. I.R.C. § 6012(a)(2) (1993). See *supra* text accompanying note 129 for text.

253. *Green*, 963 F.2d at 790.

254. *Id.*

255. See *supra* notes 202-07 and accompanying text.

256. See *supra* notes 122-84 and accompanying text.

257. *Kelley v. Commissioner*, 877 F.2d 756, 758-59 (9th Cir. 1989).

258. *Id.* at 759.

259. See *id.* at 756.

260. *Id.*

pired for the S corporation return.²⁶¹

Unlike the Supreme Court, the Eleventh Circuit and the Tax Court rely expressly on the legislative history of section 6037 to support their positions.²⁶² The Supreme Court stated that its conclusion was based on the relevant statutory language, and, further, that the use of the legislative history was unnecessary to reach its holding.²⁶³ The Supreme Court, however, then proceeded to discuss the legislative history in a footnote.²⁶⁴

The language upon which the Tax Court focused to validate its claim was: "Thus, for example, the period of limitations on assessment and collection of any corporate tax found to be due upon a subsequent determination that *the corporation was not entitled to the benefits of subchapter S*, will run from the date of filing of the return required under the new section 6037."²⁶⁵ The Tax Court interpreted this passage to mean that the S corporation return is the return that starts the running of the section 6501(a) statute of limitations only when the S election is later found invalid.²⁶⁶ By focusing on the above italicized language, the Tax Court ignored the language that begins the sentence, "Thus, for example, . . ."²⁶⁷ One example is not indicative of the exhaustive list of possible situations to which the legislation was meant to apply. The legislative history simply does not say what the Tax Court claimed it says.

The Supreme Court and the Eleventh Circuit, in a nod to the Ninth Circuit, recognized that one example is not inclusive of all the possibilities meant to be covered by that paragraph of legislative history.²⁶⁸ The Eleventh Circuit, however, failed to elaborate on any other reasons.²⁶⁹ The Eleventh Circuit, instead, analyzed the legislative history of section 6037 by relying on Congress' interpretation of the then—present state of the law when enacting the unified assessment provisions.²⁷⁰

The Supreme Court, in *Bufferd*, stated that the use of the legislative history for the enactment of unified assessment provisions to interpret section 6037 is inappropriate.²⁷¹ The congressional intent behind section

261. *Id.*

262. *Fehlhaber v. Commissioner*, 94 T.C. 863, 866-67 (1990), *aff'd*, 954 F.2d 653, 656 (11th Cir. 1992).

263. *Bufferd v. Commissioner*, 113 S. Ct. 927, 931-32 n.10 (1993).

264. *Id.*

265. *Fehlhaber*, 94 T.C. at 867 (citing S. REP. NO. 1983, 85th Cong., 2d Sess. (1958)) (emphasis added).

266. *Fehlhaber*, 94 T.C. at 868.

267. S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), *reprinted in* 1958 U.S.C.C.A.N. 4791, 5014.

268. *Bufferd*, 113 S. Ct. at 931-32 n.10; *Fehlhaber*, 954 F.2d at 656.

269. *See Fehlhaber*, 954 F.2d at 656.

270. *Id.* at 656-57.

271. *Bufferd*, 113 S. Ct. at 931-32 n.10.

6037, as evidenced by the legislative history, must have some meaning independent of the congressional enactment of unified assessment provisions. This is especially true considering that section 6037 was enacted a full twenty-four years before the unified assessment provisions.

The other reason offered by the Supreme Court for the use of the language, "Thus, for example, . . .," in the legislative history for the enactment of section 6037, is that it allows section 6037 to apply to S corporations subject to a corporate income tax.²⁷² The Supreme Court suggested that if the legislative history of section 6037 did not contain this particular language, the Service could argue that the limitations period for a corporate level capital gains tax begins only with the filing of the shareholder's return.²⁷³

As has been noted several times herein,²⁷⁴ an S corporation subject to a corporate level tax is subject to taxation under subtitle A. A corporation subject to taxation under subtitle A is required by section 6012(a)(2) to file a return.²⁷⁵ A return filed pursuant to section 6012(a)(2) is a return for purposes of section 6501(a).²⁷⁶ Therefore, for S corporations that owe a corporate tax, the Code prescribes a three year statute of limitations regardless of the presence or absence of section 6037(a).²⁷⁷ The Supreme Court's analysis failed to adequately explain the language, "Thus, for example, . . .," present in the legislative history of section 6037.

The Ninth Circuit's interpretation of section 6037 gives full effect to the statutory language and the congressional intent as evidenced by the legislative history. The alternate interpretations of the statutory language and the legislative history of section 6037 offered by the Supreme Court, the Eleventh Circuit, the Fifth Circuit, the Second Circuit, and the Tax Court, are neither as logical nor as consistent as the Ninth Circuit's interpretation.

272. *Id.*

273. *Id.*

274. *See, e.g., supra* notes 132-38 and accompanying text.

275. *See* I.R.C. § 6012(a)(2) (1993). *See supra* text accompanying note 129 for text.

276. *See supra* notes 128-31 and accompanying text.

277. *See supra* section 132-38 and accompanying text.

3. Other Arguments

a. Precedents

i. *Automobile Club of Michigan v. Commissioner*

The Supreme Court and the Tax Court partially relied on the case of *Automobile Club of Michigan v. Commissioner*²⁷⁸ for their holdings.²⁷⁹ That case involved an organization that had its tax exempt status revoked.²⁸⁰ The taxpayers argued that their filing of the Form 990 return required by section 54(f)²⁸¹ of the 1943 Code constituted the filing of a

278. 353 U.S. 180 (1957).

279. See *Buffered v. Commissioner*, 113 S. Ct. at 927, 930 (1993) (citing *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957) (citing *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944))). See also *Fehlhaber v. Commissioner*, 94 T.C. 863, 869 (1990), *aff'd*, 954 F.2d 653, 656 (11th Cir. 1992).

280. *Automobile Club*, 353 U.S. at 182.

281. I.R.C. § 54(f) (West 1943). Section 54(f) states:

Every organization, except as hereinafter provided, exempt from taxation under section 101, shall file an annual return, which shall contain or be verified by a written declaration that it is made under the penalties of perjury, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner, with the approval of the Secretary, may by regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary may from time to time prescribe. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 101-

(1) which is a religious organization exempt under section 101(6) or

(2) which is an education organization exempt under section 101(6), if such organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(3) which is a charitable organization, or an organization for the prevention of cruelty to children or animals, exempt under section 101(6), if such organization is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or is primarily supported by contributions of the general public; or

(4) which is an organization exempt under section 101(6), if such organization is operated, supervised, or controlled by or in connection with a religious organization described in paragraph (1); or

(5) which is an organization exempt solely under section 101(3); or

(6) which is an organization exempt under section 101(15), if such organization is a corporation wholly owned by the United States or any agency or instrumentality thereof, or a wholly owned subsidiary of such a corporation.

Id.

return for statute of limitations purposes.²⁸² Thus, the running of the limitations period from the filing of the Form 990 return would have prevented the Service from making assessments against the automobile club for past years in which the tax exempt status of the organization was later revoked.²⁸³ The Supreme Court rejected the taxpayers' argument.²⁸⁴ Both the *Buffered* Court and the Tax Court sought to strengthen their position by comparing the Form 990 returns to an S corporation return.²⁸⁵

The use of *Automobile Club* weakens the reasoning of the Supreme Court and the Tax Court and strengthens the interpretation made by the Ninth Circuit in several ways. To begin, *Automobile Club* is dated, and has, in fact, been so since the day it was announced. Although the decision was announced in 1957, the Form 990 returns at issue were filed in the mid 1940's.²⁸⁶ By 1954, the Internal Revenue Code had been amended to provide that returns filed by a tax exempt organization in good faith start the statute of limitations running even if that organization is later determined to be a taxable organization.²⁸⁷ This amendment has been retained as code section 6501(g)(2).²⁸⁸ Any doubt as to the meaning of this section was resolved when the Service issued Revenue Ruling 60-144, which states that Form 990 returns filed in good faith "will be deemed the return of the organization for purposes of starting the running of the statute of limitations."²⁸⁹

Even if *Automobile Club* had not been overruled, the language and legislative history of the relevant code sections show the differences between the Form 990 returns at issue in *Automobile Club* and the S corpo-

282. *Automobile Club*, 353 U.S. at 181.

283. *Id.* at 187.

284. *Id.*

285. *Fehlhaber v. Commissioner*, 94 T.C. 863, 869 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992).

286. *Automobile Club*, 353 U.S. at 181.

287. I.R.C. § 6501(g)(2) (West 1954). Section 6501(g)(2) provides:

If the taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if such taxpayer is thereafter held to be a corporation for the taxable year for which the return is filed, such return shall be deemed the return of the corporation for purposes of this section.

Id.

288. I.R.C. § 6501(g)(2) (1993). For the text of this section, which is the same as the version in the 1954 Code, see *supra* note 287.

289. Rev. Rul. 60-144, 1960-1 C.B. 638.

ration returns discussed in this article. Looking at section 54(f)²⁹⁰ and its current equivalent, section 6033,²⁹¹ the language does not indicate that a return filed pursuant to that section is to be treated as a return filed under section 6012 for limitations purposes as the language in section 6037(a) requires.²⁹² This difference in statutory language indicates that each section should be interpreted differently.²⁹³ The difference in the legislative history of section 54(f) of the 1943 Code and the legislative history of section 6037(a) also underscores the difference between the tax exempt organization returns at issue in *Automobile Club* and the S corporation returns at issue in the cases under discussion in this Article. The legislative history of section 54(f) explicitly states that the return filed by a tax exempt organization is an "informational return;"²⁹⁴ the legislative history of section 6037 does not.²⁹⁵ In fact, the legislative history of section 6037 suggests the opposite.²⁹⁶

Lastly, the citation to *Automobile Club* underscores how a return that fails the common law definition of a "return" for section 6501(a) purposes may be elevated to the status of a section 6501(a) return by another section of the Code. In *Automobile Club*, the Supreme Court held that the returns filed by the non-profit corporation did not start the statute of limitations running.²⁹⁷ Congress, however, overturned the specific holding of *Automobile Club* when it enacted a code section that stated that the informational return of a non-profit corporation started the statute of

290. See *supra* note 280.

291. I.R.C. § 6033 (1993). Section 6033(a)(1) states in relevant part:

Except as provided in paragraph (2), every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the item of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe; except that, in the discretion of the Secretary, any organization described in section 401(a) may be relieved from stating in its return any information which is reported in returns filed by the employer which established such organization.

Id.

292. I.R.C. § 6037(a) (1993). See *supra* text accompanying note 140.

293. Cf. *Siben v. Commissioner*, 930 F.2d 1034 (2d Cir.), *cert. denied*, 112 S. Ct. 429 (1991); *Stahl v. Commissioner*, 96 T.C. 798 (1991) (observing that I.R.C. § 6031(a) (1993) and I.R.C. § 6037(a) (1993) contain different language and should be applied differently).

294. See S. REP. NO. 627, 78th Cong., 1st Sess. 21 (1943). "Under the house bill, these exempt corporations are required to file returns of income for taxable years beginning after December 31, 1942, in order to secure sufficient information to determine whether such corporations should be subject to taxation." *Id.*

295. See *supra* text accompanying note 173.

296. See *supra* notes 159-81 and accompanying text.

297. *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957).

limitations running if it was filed in good faith.²⁹⁸ Section 6037(a) has the same effect for S corporation returns as section 6501(g) has on the returns filed by non-profit corporations. Section 6037(a), by its interaction with section 6012, elevates a return that ordinarily would not be treated as a "return" by the common law to the status of a section 6501(a) "return."²⁹⁹

ii. *Leonhart v. Commissioner*

In addition to the legislative history and *Automobile Club of Michigan v. Commissioner*,³⁰⁰ the Tax Court relied on the case of *Leonhart v. Commissioner*.³⁰¹ In *Leonhart*, two S corporation shareholders claimed that the Service was barred from adjusting their tax liability for items relating to the S corporation on the basis that the three year statute of limitations had run on their S corporation return.³⁰² The statute of limitations had not run on the shareholder's individual tax liability.³⁰³ The Tax Court ruled that an S corporation return filed pursuant to section 6037 triggered the running of the statute of limitations only if the subchapter S election was later shown to be invalid.³⁰⁴ The Tax Court in *Leonhart* cited the same passage of legislative history on which the *Fehlhaber* Tax Court relied.³⁰⁵ Although the *Leonhart* case is precedent, its reasoning is no more compelling today than when it was decided.

b. *The assessment argument*

A closer examination of *Buffered* reveals that the taxpayer argued that C corporation returns could not be adjusted after the limitations period had run.³⁰⁶ The Court questioned this conclusion and noted that the taxpayer cited no authority for it.³⁰⁷ Similar analysis was used by the Sec-

298. Pub. L. No. 83-591, 68 Stat. 730 (1954).

299. See *supra* notes 122-58 and accompanying text.

300. 353 U.S. 180 (1957).

301. 27 T.C.M. (CCH) 443 (1968); see also *Fehlhaber v. Commissioner*, 94 T.C. 863, 867 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992) (citing *Leonhart v. Commissioner*, 353 U.S. 180 (1957)).

302. *Id.* at 462.

303. *Id.*

304. *Id.*

305. *Id.* at 462-63.

306. *Buffered v. Commissioner*, 113 S. Ct. 927, 932-33 n.11 (1993).

307. *Id.*

ond Circuit in its *Bufferd* opinion.³⁰⁸ The Second Circuit suggested that an adjustment to the tax return of an S corporation more than three years after the filing of its return is not an “assessment” for purposes of section 6501(a).³⁰⁹ The Second Circuit stated: “Section 6501(a) does not bar adjustments to an entity’s return that do not result in a tax assessment on that entity.”³¹⁰

Following the Second Circuit’s “assessment” rationale, adjustments relating to the tax items of the S corporation could still be made if the S corporation’s tax liability is not changed. Since an S corporation that owes tax at the corporate level still “passes-through” the tax items relating to other income not taxed at the corporate level, an adjustment to those tax items would not change the corporation’s tax liability. Therefore, the broad interpretation of the Supreme Court’s language in *Bufferd* is consistent with the “assessment” analysis of the Second Circuit.³¹¹ If the broad interpretation is adopted, the government’s position in the cases discussed in this article is correct.

A narrow interpretation, however, is more consistent with the position adopted by four circuit courts of appeal and the Tax Court.³¹² If the Supreme Court were to expressly adopt the narrow interpretation of the language in the *Bufferd* opinion, and hold that no assessment could be made to the return of a shareholder of an S corporation that owed corporate level tax after the limitations period for assessment against the S corporation had expired, the Second Circuit’s “assessment” rationale would be compromised.

In *Bufferd*, the Supreme Court appeared to be influenced by the government’s citation of authority that countered the taxpayer’s claim that a C corporation’s return could not be adjusted after the statute of limitations period.³¹³ The government cited *Commissioner v. Munter*.³¹⁴ *Munter* involved a dispute between the shareholders of a corporation and the Service regarding whether a corporate distribution was a dividend or a return of capital.³¹⁵ The shareholders claimed that the corporation lacked sufficient earnings and profits to distribute a divi-

308. *Bufferd v. Commissioner*, 952 F.2d 675, 677 (2d Cir. 1992).

309. *Id.*

310. *Id.* at 677.

311. *See Bufferd v. Commissioner*, 952 F.2d 675, 677 (2d Cir. 1992).

312. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992), *cert. denied*, 113 S. Ct. 1251 (1993); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992), *aff’g* 94 T.C. 863 (1990); *Fendall v. Commissioner*, 906 F.2d 362 (8th Cir. 1990); *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989).

313. *Bufferd*, 113 S. Ct. at 932-33 n.11 (citing *Commissioner v. Munter*, 331 U.S. 210 (1947)).

314. 331 U.S. 210 (1947).

315. *Id.* at 211-12.

dividend.³¹⁶ The government claimed that the distributing corporation, which resulted from a merger that occurred in 1928, succeeded to the earnings and profits of the predecessor corporations.³¹⁷ Therefore, the corporation had sufficient earnings and profits to make the distribution a dividend.³¹⁸ The Supreme Court was persuaded by the government's observation that the statute of limitations issue was not discussed in the *Munter* opinion.³¹⁹

While *Bufferd's* citation to *Munter* may have some merit, it is weak support for the Supreme Court's broad conclusion that follows. Unlike the S corporation items, earnings and profits are generally not reported as part of a corporation's income tax return. Issues relating to the existence or absence of earnings and profits would not arise until a corporate distribution took place.³²⁰ The distribution at issue in *Munter* was made in 1940.³²¹ The three year statute of limitations in effect at the time³²² would not have run on a return filed on April 15, 1941 until April 15, 1944. The Tax Court issued its opinion in the *Munter* case on May 22, 1945.³²³ Therefore, it is very likely that the Service's assessment was made in a timely manner. However, neither the Tax Court opinion,³²⁴ the circuit court opinion,³²⁵ nor the Supreme Court opinion³²⁶ in *Munter* state when the Service's assessment was made. While it is possi-

316. I.R.C. § 301(a) (1993). Section 301(a) states the general rule for corporate distributions: "Except as otherwise provided in this chapter, a distribution of property . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." *Id.* I.R.C. § 301(c)(1) (1993) further provides that "the portion of the distribution which is a dividend (as defined in I.R.C. § 316 (1993)) shall be included in gross income. The remaining portion of the distribution is applied against and reduces the shareholder's adjusted basis in his/her stock." I.R.C. § 301(c)(2) (1993). Any portion of the distribution in excess of the shareholder's adjusted basis is treated as capital gain. I.R.C. § 301(c)(3) (1993).

I.R.C. § 316(a) (1993), which defines the portion of the distribution which is a dividend, states: "For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913," *Id.*

317. *Munter*, 331 U.S. at 215-16.

318. *See supra* note 316.

319. *See Bufferd v. Commissioner*, 113 S. Ct. 927, 932-33 n.11 (1993).

320. *See supra* note 316.

321. *Munter*, 331 U.S. 210.

322. I.R.C. § 275(a) (1993).

323. *Munter v. Commissioner*, 5 T.C. 108 (1945).

324. *Id.*

325. *Munter v. Commissioner*, 157 F.2d 132 (3rd Cir. 1946).

326. *Commissioner v. Munter*, 331 U.S. 210 (1947).

ble that the statute of limitations defense was available to the shareholders in *Munter*, it is more likely that it was not. The facts, as stated in the three court opinions, do not provide the information necessary to determine the availability of the statute of limitations defense.

Secondly, the statute of limitations is an affirmative defense.³²⁷ To bar an assessment, the taxpayer in *Munter* would have had to raise the issue.³²⁸ It is unlikely that an affirmative defense raised by the taxpayer would have been completely ignored by the Tax Court, the circuit court, and the Supreme Court. These alternate rationales most likely explain why the Supreme Court opinion in *Munter* did not discuss the statute of limitations issue.

In addition to the weakness of authority cited by the Supreme Court, the "assessment" rationale conflicts with Congress' intent in enacting section 6037. As noted earlier,³²⁹ at the time section 6037 was enacted it applied to only two organizations: C corporations that filed S corporation returns pursuant to an invalid S election, and S corporations that filed S corporation returns pursuant to a valid election. Although one goal of section 6037 was to clarify the application of the statute of limitations to S corporations that file an S corporation return pursuant to an invalid election, it also applies to S corporations that file a return pursuant to a valid S election and do not owe a corporate level tax. The only purpose for making the statute of limitations applicable to an S corporation that is not subject to tax is to provide a statute of limitations to the shareholders of the corporation through which the S corporation items flow. The "assessment" rationale of the Second Circuit and the broad interpretation of the Supreme Court language in *Bufferd* violates the congressional intent of section 6037.

A more significant objection to the "assessment" rationale of the Second Circuit is its effect upon the concept of a statute of limitations. The purpose of a statute of limitations is to provide some assurance that at some point records may be safely discarded.³³⁰ If the Service may adjust returns without assessment at any time, the taxpayer disposes of old records at his own risk. This is especially true for any tax attributes that are carried over from year to year. Consistent with the broad interpretation of the language of the Supreme Court opinion in *Bufferd*, the Service could make an adjustment without assessment to any item on a tax return for which the statute of limitations has expired. That adjustment, in turn, may affect a tax attribute in a year currently open under the stat-

327. MERTENS, *supra* note 99, § 57.97 (citing *Talbot Walker v. Commissioner*, 27 B.T.A. 829 (1933)).

328. *Id.*

329. *See supra* notes 171-81 and accompanying text.

330. *Kelley v. Commissioner*, 877 F.2d 756, 758 (9th Cir. 1989).

ute of limitations for which the Service makes a contemporaneous assessment. The taxpayer is forced to show that the adjustment made in the prior year, which now affects current income tax liability, is erroneous. If the Second Circuit's concept of an adjustment without assessment becomes the law, the assurance offered by a statute of limitations provision becomes severely diminished.

While the Supreme Court, the Second Circuit, and those who agree with their opinions in *Bufferd* may try to limit the "assessment" rationale to the case of S corporations that do not pay tax, this is not possible. Resolving the issue of how the statute of limitations applies to S corporations and their shareholders by interpreting the word "assessment" in section 6501(a), requires that the rationale be applied to all returns subject to the provisions of section 6501(a). The Supreme Court leaves open the possibility that adjustments without assessments may be made to the returns filed by any taxpayer after the statute of limitations has expired.³³¹

C. *The Policy Concerns*

1. Overview

When examining the Ninth Circuit's opinion in *Kelley v. Commissioner*,³³² the circuit courts and the Tax Court assert that the holding in *Kelley* rests primarily on policy considerations.³³³ The Supreme Court in *Bufferd* noted that policy concerns contributed to the decision reached in *Kelley*.³³⁴ While the *Kelley* opinion gives a thorough discussion of the policy issues associated with the dispute under discussion,³³⁵ the Ninth Circuit did not begin to address those issues until it had analyzed the statutory language of section 6037.³³⁶ The *Kelley* court then followed the discussion of policy concerns with an analysis of legislative history.³³⁷ Courts that have examined the *Kelley* opinion address the policy concerns raised by the Ninth Circuit, but they do not indicate why the analysis of the statutory language and legislative history also contained in that

331. *Bufferd v. Commissioner*, 113 S. Ct. 927, 932-33 n.11 (1993).

332. 877 F.2d 756 (9th Cir. 1989).

333. *Green v. Commissioner*, 963 F.2d 783, 789 (5th Cir. 1992); *Fehlhaber v. Commissioner*, 954 F.2d 653, 657 (11th Cir. 1992), *aff'g* 94 T.C. 863 (1990).

334. *Bufferd*, 113 S. Ct. at 931-32 n.10.

335. *Kelley*, 877 F.2d at 758.

336. *Id.*

337. *Id.* at 759.

opinion is flawed.³³⁸ As shown above,³³⁹ the interpretation given to the relevant code sections by courts other than the Ninth Circuit is not as logical as the Ninth Circuit's reasoned opinion on these issues.³⁴⁰

2. The Arguments

In *Kelley*, the Ninth Circuit expressed the idea that statutes of limitation exist so that a taxpayer may confidently dispose of old corporate records.³⁴¹ The court noted that the Service can easily request an extension of the limitations period if it so desires.³⁴² The Tax Court addressed the policy concerns raised by the Ninth Circuit as well as raising some counter policy concerns of its own.³⁴³ Other courts that have examined the issue have repeated the Tax Court's refutation of the Ninth Circuit's policy arguments; however, they do not offer any new counter-policy considerations.³⁴⁴

The Tax Court responded to the Ninth Circuit's concerns with three arguments:

1. Statutory construction to avoid perceived unfairness conflicts with the settled rule that statutes of limitation are to be strictly construed.
2. It is not unusual for an individual's tax responsibility to be construed from the book's of another entity.
3. Generally, there is only one shareholder in an S corporation.³⁴⁵

The Tax Court's response to the policy concerns of the *Kelley* opinion has some merit. A court's belief that a statute works unfairness on the taxpayer should not control how it interprets the statute if such an interpretation would conflict with the rules of statutory construction.³⁴⁶ However, the Ninth Circuit's analysis of code section 6037 rests on statutory language and legislative history, not policy considerations, which simply support the conclusions already reached.³⁴⁷

The second concern, that the individual taxpayer's liability often relies on the books of another entity, is a point of some merit when evaluating

338. See *Bufferd*, 113 S. Ct. at 927; *Green*, 963 F.2d at 783; *Fehlhaber*, 952 F.2d at 653.

339. See *supra* notes 185-331 and accompanying text.

340. See *Kelley*, 877 F.2d at 756.

341. *Id.* at 758.

342. *Id.*

343. *Fehlhaber v. Commissioner*, 94 T.C. 863, 970, *aff'd*, 954 F.2d 653 (11th Cir. 1992).

344. *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993), *aff'g* 952 F.2d 675 (2nd Cir. 1992); *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992); *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992).

345. *Fehlhaber*, 94 T.C. at 870.

346. See *supra* notes 99-121 and accompanying text.

347. *Kelley v. Commissioner*, 877 F.2d 756, 758 (9th Cir. 1989).

the fairness arguments. However, as noted by the Tax Court, a fair result should not be chosen if it is inconsistent with the result reached through the application of the rules of statutory construction.³⁴⁸ The courts examining the *Kelley* opinion should concern themselves with the Ninth Circuit's interpretation of the relevant statutory language and legislative history. The third argument is an unsupported assertion of fact that should not be given any consideration.

In addition to refuting the policy concerns of the Ninth Circuit, the Tax Court raised concerns about the effects of the Ninth Circuit's interpretation on the taxpayer and the Service.³⁴⁹ It is important to note, however, that such policy concerns should not prevent the Tax Court, or any other court, from first examining the statutory language and legislative history of the relevant code sections.³⁵⁰ The first issue the Tax Court raised related to a shareholder of an S corporation who failed to file an individual return.³⁵¹ The Tax Court was concerned that an individual without a statute of limitations defense for his individual tax assessment would receive the benefit of a three year statute of limitations on the S corporation return and the items contained within it.³⁵² Conversely, the Tax Court was concerned about the scenario of the S corporation not filing a return. In that case, the Service's ability to make adjustments to the pass-through items of the S corporation would be governed by the limitations period on the individual's tax return.³⁵³

The concerns raised by the Tax Court about the unintended consequences to the taxpayer and the Service caused by the Ninth Circuit's interpretation are not problematic. The Tax Court's concern is how the statute of limitations will be affected if only one return, either the shareholder's or the S corporation's, is filed. In either situation, the current rules can be satisfactorily applied.

If only the S corporation filed a return, the three year statute of limitations would run as to the S corporation return, but no statute of limita-

348. *Fehlhaber*, 94 T.C. 863, 870 (1990), *aff'd*, 954 F.2d 653 (11th Cir. 1992).

349. *Fehlhaber*, 94 T.C. at 870.

350. *See supra* notes 99-121.

351. *Fehlhaber*, 94 T.C. at 870.

352. *Fehlhaber*, 94 T.C. at 870; *see also* I.R.C. § 6501(c)(3) (1993). Section 6501(c)(3) states: "In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time." *Id.*

353. *See* I.R.C. § 6501(a) (1993). *See supra* note 7 for text.

tions would run on the individual return.³⁵⁴ The Service could fix the assessment of the S corporation tax items by giving notice to the S corporation or to the last known address of the shareholder. When the shareholder paid his tax liability he would be charged for the S corporation items as the Service assessed them.

If the S corporation fails to file a return, but the shareholder files a return, the Service, as a practical matter, can find the individual and inquire about the corporate return.³⁵⁵ Regardless, the shareholder must still include the S corporation tax items on his return. If, by omitting the S corporation tax items, the shareholder of the S corporation files a false return with an intent to evade tax, the tax may be assessed or collected through the courts at any time.³⁵⁶

VI. CONCLUSION

After examining the statutory language³⁵⁷ and the legislative history³⁵⁸ of the relevant code provisions, the reasoning used by the Ninth Circuit in *Kelley v. Commissioner*³⁵⁹ is more logical than the interpretations of these provisions made by the Supreme Court,³⁶⁰ the Fifth Circuit,³⁶¹ the Eleventh Circuit,³⁶² and the Second Circuit.³⁶³ The only alternate analysis offered by these courts that supports the government's position seriously infringes on the concept of a statute of limitations.³⁶⁴ The other interpretations offered by those courts that disagree with the Ninth Circuit's decision in *Kelley v. Commissioner* fail to give effect to language present in section 6037(a),³⁶⁵ the congressional intent behind the statute as derived from the legislative history,³⁶⁶ and the general presumption that S corporations should be treated as C corporations found

354. See I.R.C. § 6501(c)(3) (1993). See *supra* note 352 for text.

355. *Id.*

356. I.R.C. § 6501(c)(1) (1993). Section 6501(c)(1) states: "In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time." *Id.*

357. See *supra* notes 122-58 and accompanying text.

358. See *supra* notes 159-84 and accompanying text.

359. 877 F.2d 756 (9th Cir. 1989).

360. *Bufferd v. Commissioner*, 113 S. Ct. 927 (1993).

361. *Green v. Commissioner*, 963 F.2d 783 (5th Cir. 1992).

362. *Fehlhaber v. Commissioner*, 954 F.2d 653 (11th Cir. 1992).

363. *Bufferd v. Commissioner*, 952 F.2d 675 (2d Cir. 1992).

364. See *supra* notes 306-31 and accompanying text.

365. See *supra* notes 185-256 and accompanying text.

366. See *supra* notes 257-77 and accompanying text.

in section 1371(a).³⁶⁷ Following the better interpretation of the interaction of sections 6037(a), 6012, and 6501(a), offered by the Ninth Circuit³⁶⁸ and developed in this article,³⁶⁹ the Service should be barred by the statute of limitations from making assessments of tax attributable to items reported on the S corporation return against shareholders of an S corporation after the three year statute of limitations on the S corporation return expires.

367. See *supra* note 221 and accompanying text.

368. *Kelley*, 877 F.2d at 756.

369. See *supra* notes 122-84 and accompanying text.

